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VOLUME 5 • NUMBER 5
COMPLETE TABLE OF CONTENTS • PAGE 257
INDEX OF CURRENT CASES • PAGE 321

THE JOURNAL OF Taxation

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Appellate decision in Agran retrial holds CPA practiced law in tax case

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What the new Agran decision means to tax practice by non-lawyers

by Reuben Clark, Jr.

Present legal basis for deductibility of travel & entertainment expenses

by Melvin Orenstein

November 1956

Formula for profit-sharing plan is still desirable; other new developments 258
Using the new statutory custodian for gifts to minors 263
Beware of hysteria over deductibility of travel expenses 266
New Agran decision raises constitutional questions 271
Lawyers don't want controversy with CPAs over tax practice 273
Tax Court backlog now some 9,000 cases 276
AIA denies CPAs are dissatisfied with new Regulations 277
Johnson case solves some problems of installment seller 280
Fast depreciation not widely adopted; problems it creates 284
Treasury wants to close coop tax escape hatch 285
Problems of co-owners electing to be treated as partnership 290
Should one cooperate with IRS in fraud investigation 295
Proposed Regs do not clarify "exempt organizations" status 298
State taxation of interstate business under the commerce clause 303
The changing nature of "income in respect of a decedent" 310
Management can use close corp. to develop stock interests 314
Using a close corporation to carry initial-loss venture 315
Long-time hazard in transfer of close corporation stock 317
Acquiring business to avoid tax; factors to consider 318
Liquidation followed by reincorporation; can you get desired tax treatment 319

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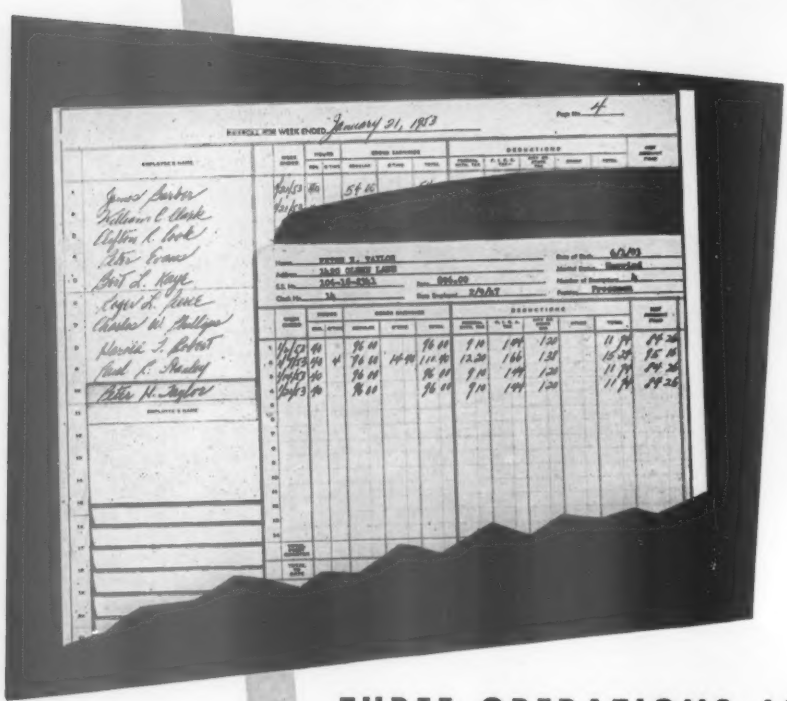

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November contents

REGULAR DEPARTMENTS

Accounting • 280

280 Johnson case solves some problems of the installment seller, *by Arno Herzberg*

282 Receipts later refunded bring tax burden when less than $3,000; escrow may help

283 New case where salvage exceeds book value may not be precedent

283 Shortcut worksheet for sum-of-the years digit depreciation

284 Fast depreciation not widely adopted; possible EPT, accounting problems ensue

285 Treasury wants to close door through which coops escape taxation

285 New accounting decisions

Compensation • 258

258 Formula for profit-sharing plan still desirable despite new IRS rule, *by Joseph L. Seligman, Jr.*

262 New compensation decisions

Corporate organization • 314

314 Management can obtain and retain stock interest through close corporation

315 Using a Corp. to carry initial-loss venture

315 Capital gain on real-estate subdivision without waiting

316 Ruling reversing Citizens Utilities plan under review

317 Long-time tax hazard in transfer of close corporation stock

318 Factors to consider under Section 269 when acquiring businesses to avoid tax, *by Kenneth Liles*

319 Liquidation followed by reincorporation; can you get tax treatment you want?

320 New corporate decisions

Estate and Gift Taxation • 263

263 When and how to use the new statutory custodian for gifts to minors, *by M. R. Schlesinger*

264 New estate and gift decisions this month

Fraud • 295

295 To cooperate or not to cooperate in fraud investigation: 14 rules

296 New fraud decisions

Partnerships • 290

290 Tax problems of co-owners electing to be treated as a partnership under new rules, *by Waymon G. Peavy*

Personal • 266

266 Courts are still final arbiter of what travel expenses are deductible; beware hysteria, *by Melvin Orenstein*

270 New decisions affecting individuals

Planning • 298

298 Proposed Regulations do not clarify tax status of "exempt organizations," *by Andrew B. Young and Charles O. Galvin*

Practice • 271

271 Final Agran decision says CPA practiced law; Treasury interpretation ignored

271 New Agran decision raises constitutional questions; confuses rules of tax practice, *by Reuben Clark, Jr.*

272 Complete text of Agran decision

273 Controversy with CPAs over tax practice not wanted by most lawyers, says Bar official

Procedure • 276

276 Tax Court backlog now some 9,000 cases; 1954 Code cases not heavy yet

277 AIA denies that CPAs are dissatisfied with issuance of new Regulations

277 "Quota system" is dead, says Commissioner Harrington

278 Audit chiefs to head up conference staff

278 New procedural decisions

State and local taxation • 303

303 State taxation of interstate business under the Commerce Clause, *by Jerome R. Hellerstein*

308 Penna. determines tax situs of cash, receivables

309 North Carolina CPAs study state tax system

309 Tax Institute to study highway taxes

309 New state-tax decisions

Trust and estate taxation

310 The changing nature of "income in respect of a decedent," *by James H. Kindel, Jr.*

Miscellaneous new decisions • 313

321 Index of new decisions in this issue

321 Classified advertising

CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Profit-sharing formula still desirable despite new IRS rule; other new developments

by **JOSEPH L. SELIGMAN, JR.**

The IRS has finally agreed that a profit-sharing plan need not use a definite, fixed formula. However, many tax men still see considerable advantage to the taxpayer in using such a formula. Mr. Seligman takes this position, and explains his reasons. He also reports here on these other new developments in pension and profit-sharing plans: common or pooled investment funds, cash withdrawals, supplementary benefits, unfair results of IRS definition of "employee," prohibited transactions, capital gains on lump-sum payments, and related matters. This article is adapted from a paper written for the Western Regional Trust Conference.

WHEN THE NEW pension and profit-sharing regulations came out, the provision that struck most tax men as most noteworthy was the elimination of the requirement that a qualified profit-sharing plan contain a definite predetermined formula fixing the employer's contribution. The House version of the 1954 Code had expressly stated that no such formula was required in a qualified plan, but the Senate deleted this provision. In the absence of change in the statutory language, the omission in the proposed Regulations was a complete and sudden reversal of the Commissioner's position. At long last, he was apparently accepting the doctrine of the three court decisions[1] which had held that no such requirement could be inferred from the 1939 Code. His abrupt about-face was completed in T.D. 6189,[2] which held that the definite predetermined formula was no longer necessary under Section 165(a) of the 1939 Code. This decision was followed shortly by Revenue Procedure 56-22,[3] which stated that a new determination letter was not necessary and need not be requested where such a formula was deleted from an existing qualified profit-sharing plan.

And so it is now quite clear after 12 years of controversy and litigation that a definite predetermined formula is not legally essential to the qualification of a profit-sharing plan either under the 1939 or 1954 Code. There are many who feel that the battle is won and that the issue can now be forgotten. This, I think, is wishful thinking. A number of danger signals, both official and informal, have emanated from the Service, and all seem to suggest that an employer who omits or deletes the definite predetermined formula from a qualified profit-sharing plan does so at his peril. Thus, Section 1.401-1(b)(1)(ii) of the proposed Regulations cautions:

"A plan (whether or not it contains a definite predetermined formula for determining the profits to be shared with the employees) does not qualify under Section 401(a) if the contributions to the plan are made at such times or in such amounts that the plan in operation discriminates in favor of officers, shareholders, persons whose principal duties consist in supervising the work of other employees, or highly compensated employees."

In speaking before the Western Pension Conference in San Francisco last year, Mr. Goodman [see 4 JTAX 341] called attention to the implications of this sentence. He noted that P.S. No. 57,[4] which was issued in 1946, states that a prior qualification ruling does not apply if employer contributions are not made in accordance with a definite formula provided in the plan. He gave as an example a case where substantial contributions are made while highly-paid employees predominate but are discontinued or made in inconsequential amounts when others become eligible. In this type of situation, Mr. Goodman suggested that the Commissioner should be notified and the case processed as a curtailment or termination of the plan. If it is so processed, one should keep in his mind Revenue Ruling 55-186.[5] This purports to require that all qualified plans contain appropriate provisions granting full vesting to any employee who terminates while employer contributions are suspended.

Another danger where the plan does not contain a definite formula is that employer contributions made after the year end will not be deductible under Section 404(a)(6) of the 1954 Code if the legal liability to make such contributions did not exist at the year end. Revenue Ruling 56-366[6] was recently issued to call attention to this requirement and to caution that if the legal liability is created by amendment before the year end, it must, like any other provision of a qualified plan, be definite, written and communicated to employees.

In addition to these written warnings, I think it fairly clear that the Service has not accepted the *Lincoln Electric* doctrine to the extent that a one-shot program was approved. As you remember, in that case the employer put a million dollars into a trust to be distributed to employees upon certain terms and conditions. There was no thought of making further contributions to this trust. The Sixth Circuit held that it nevertheless qualified under Section 165(a), but the Commissioner has never accepted this view. I believe that if another situation like the *Lincoln Electric* case arose today, the Commissioner would probably seek to relitigate it.

In the light of these considerations, I believe it is unwise to adopt a profit-sharing plan that does not contain a definite formula or to delete a formula from an existing plan. There may be exceptional cases in which it is justified, although I must admit that I have never found one. Even though it is no longer a legal prerequisite to qualification, I still recommend in the strongest terms possible that any profit-sharing plan should contain a definite formula if its continued qualified status is im-

portant to either the employer or the employee participants.

If you are asked to advise on this subject, I submit that perhaps the fairest test is to ask yourself this question. Assume that the company has contributed 10% of profits to the plan for three consecutive years, and in each year that contribution has approximated $100,000. In the fourth year, although there has been no substantial change in its profits, the company wants to skip its contribution entirely or to put in $5,000 or $50,000 or $200,000. Would you be willing to recommend any substantial deviation from the $100,000 annual contribution without first checking it with the revenue agent to determine whether, in his opinion, the change would adversely affect the continued qualification of the plan. In other words, does the change make the plan discriminatory in operation, or should it be considered as a suspension of contributions? Unless you are confident that you would tell the employer to change his contribution in whatever way he wished without consulting the revenue agent, then I submit that you cannot honestly recommend the adoption of a plan which does not contain a definite predetermined formula.

If our hypothetical plan had had a 10%-of-profits formula, only a board of directors' resolution would have been necessary in the fourth year to change the formula for one year or indefinitely into the future. The amending resolution is then submitted to the revenue agent for a ruling, and a favorable determination letter assures you of a continued qualified plan. You have a clear-cut definite transaction and, in addition, you will, I believe, derive a lot more employee goodwill from a plan that contains a definite formula than one that does not.

Investment

In the last few years there has been tremendous activity in the development of common-trust funds, pooled or group trusts and the like. Each of these arrangements is designed to pool the assets of several small trusts to permit greater diversification of investments.

In general, such pooled arrangements are permissible if only the investment risk is spread out among several employers. In a private letter ruling to Manufacturers Trust, the Service held that a group trust for a number of private qualified plans could qualify. This reasoning was formalized in Revenue Ruling 56-267,[7] which held that qualified plans can pool funds in a group trust.

One interesting sidelight of this development has been the private letter ruling[8] issued by the Service July 6, 1956, to Mercantile Trust Company of St. Louis, Missouri. The transfer of assets, it said, from a qualified individual trust to a qualified pooled or group trust is a sale or exchange resulting in gain or loss. Obviously, this gain or loss is not subject to tax because both trusts are exempt. The important aspect of the ruling is that the assets have a stepped-up basis in the hands of the pooled trust which in these times of high market values may adversely affect the continued deductibility of the employer's future contributions. Thus, suppose the present actuarial liability of a qualified pension plan is $1,000,000, and the cost of the securities held in the trust is $600,000. The plan would have an unfunded actuarial liability of $400,000, and employer contributions would be deductible within the limits set forth in Section 404 until the actuarial liability is fully funded. However, if these securities are transferred to a pooled or group trust at a time when they have a market value of $1,000,000, the new value, which the ruling says must now be used, wipes out the unfunded actuarial liability and thereby prevents the employer from making any further deductible contributions to the trust. If this ruling is good law, and I find it difficult to refute the logic of its conclusion, then the cost and market values of trust assets should be carefully reviewed before they are transferred from an individual to a group trust.

Cash withdrawals

Most qualified plans were originally designed to provide benefits only on termination of service. In recent years, there has been a very noticeable desire to incorporate provisions permitting some form of cash withdrawals during service. This trend is especially prevalent among employers with qualified profit-sharing plans who seek to obtain some of the incentive value of an immediate distribution profit-sharing plan and still retain funds available for an orderly retirement program.

Under the old Regulations, a qualified profit-sharing plan must be designed to distribute "the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as illness, disability, retirement, death, or severance of employment."[9] A 1954 ruling[10] held that the fixed number of years could not be less than two; a qualified plan could not permit an employee to withdraw any part of his employer's contribution within two years after the date on which it was contributed. Shortly thereafter, another ruling[11] held that an employee's interest would be considered to have been made available to him within the meaning of Section 165(b) at the earliest date upon which he could have received a lump-sum distribution from the trust. In other words, the employee would be considered as having constructively received the distribution on the first date when he acquired an unqualified right to withdraw it.

This last ruling was somewhat modified by three companion rulings[12] issued in July of last year. Starting with the premise that there is no constructive receipt until a participant's interest is unconditionally available to him, the first ruling found that it is not unconditionally available if there is a substantial penalty imposed for withdrawal or if the employee must make a prior irrevocable election which defers distribution to a fixed or determinable future time. Ten years was discussed as an acceptable period, and perhaps something less might also be acceptable. The second of these three companion rulings held that there was no constructive receipt where withdrawal was permitted only in the case of financial need proved to the satisfaction of the plan's administrative committee. The third ruling approved a plan where a participant could before 14 years of service irrevocably elect to receive distribution after 15 years.

The sum and substance of the Service's position seems to be that a qualified plan may give the employee the right to elect to withdraw part or all of his vested interest prior to the termination of his service if: (1) he can

[1] Lincoln Elec. Co. v. Comm'r, 190 F.2d 326 (6th Cir. 1951); Comm'r v. Produce Reporter Co., 207 F.2d 586 (7th Cir. 1953); E. R. Wagner Mfg. Co., 18 TC 657 (1942).
[2] IRB 1956-29, 58.
[3] IRB 1956-31, 33.
[4] P-H Pension and Profit-Sharing Serv. ¶9556.
[5] 1955-1 CB 39.
[6] IRB 1956-31, 26.
[7] IRB 1956-25, 17.
[8] P-H Pension and Profit-Sharing Serv. ¶11,922.
[9] Regs. 118, §39.165-1(a).
[10] Rev. Rul. 54-231, 1954-1 CB 150.
[11] Rev. Rul. 54-265, 1954-2 CB 239.
[12] Rev. Ruls. 55-423, 55-424, 55-425,1955-1 CB 41, 42, 43.

prove financial necessity, such as illness in the family; or (2) there is a substantial penalty attached to the election to withdraw, such as suspension from the right to participate for a year or more or forfeiture of a part of his interest; or (3) the employee is required to make a prior election that is irrevocable for a substantial period of time.

To avoid the constructive-receipt doctrine, some plans permit the employee to borrow from the trust an amount not exceeding his vested interest. If the loan is bona fide, there is of course no income and no tax. It is clearly bona fide if the employee is expected to repay and if interest is charged. However, if loans have been made to employees without interest and without repayment prior to termination of service, the Commissioner might well contend that the loan was a sham and treat the transaction as a cash withdrawal.

Supplementary unemployment benefits

In the last couple of years we have read and heard a good deal about the demands of some large unions for a guaranteed annual wage. The plans which have thus far evolved from these demands are supplementary unemployment benefit plans rather than guaranteed annual wage plans. Of these SUP plans, those that are funded fall into two groups which are usually referred to as the auto-industry plans and the glass-industry plans. In the former, the employer makes irrevocable contributions to a trust to be held and administered for the benefit of all eligible employees. During periods of layoff, the trust provides income in addition to state unemployment insurance. Employees have no vested rights in the trust. In the glass-industry plans, on the other hand, there is a separate trust established for each employee in which he has a vested and nonforfeitable interest. When the balance in an employee's trust gets to $600, future employer contributions are credited to him as additional vacation pay.

The Internal Revenue Service has atempted to facilitate the introduction of these plans by liberal, realistic rulings. It first ruled[13] that Section 404 does not apply to deferred compensation plans such as SUP which are primarily unemployment benefit plans. This conclusion permitted the Service to avoid Section 404(a)(5) which would have prohibited a deduction of employer contributions under the auto plans until the year benefits were paid. On reasoning that was somewhat strained, the Service was then able to permit deduction of the contributions when made as ordinary business expense. In Revenue Ruling 56-249[14] it was held that the benefits paid under these plans are not wages subject to FOAB or SUIT or income tax withholding, but are wages for Federal income tax. Late last year, a special ruling held that a qualified profit-sharing plan could provide supplemental unemployment benefits without loss of its qualified status under Section 401(a).[15] This conclusion does not conflict with its prior determinations where primary purpose of the qualified plan was retirement, not unemployment benefits.

In March of this year, the Service issued three special tax rulings[16] dealing with the glass-industry plans. It held that the employer's contributions to each employee's individual trust are wages when paid to the trust because of each employee's vested interest and that each trust is a separate taxable entity but the consolidated fund is a tax-exempt common-trust fund. Based on this analysis, the employer's contribution when made is deductible by the employer and taxable as income to the employee and also then subject to income tax withholding and social security taxes. The California Attorney General has reached the same conclusions.

The Service has not yet ruled on the taxability of the income of a trust under an auto-type plan. While no paragraph of Section 501(c) seems directly applicable, it would not take too much stretching to grant them tax-exempt status. Many other questions still remain unanswered. As time passes, rulings and court decisions should clarify the confusion. One thing, however, seems certain. Labor's interest in guaranteed annual wages will not diminish. We will see many more SUP plans and other variations not yet devised.

Narrow IRS definition of "employee"

The biggest roadblock to the orderly development of employee benefit plans is the Service's continuing interpretation of the statutory term "employee" to exclude partners and self-employed. The Commissioner's refusal to adopt a more liberal, realistic definition has created a sharp discrimination in favor of corporate officers. This discrimination manifests itself in a number of unfortunate ways:

Today many doctors, lawyers and other professional people practice in groups of specialists such as a typical community clinic or a large law office. The partners cannot participate in a qualified retirement plan because the Commissioner says they are not employees. Despite the *Kintner* case,[17] which held to the contrary, and the admitted fact that there is no logical business or tax reason to distinguish these partners from corporate officers, the Commissioner nevertheless continues to insist that they may not participate in qualified plans.[18]

To permit qualified plans for the self-employed, a number of bills, often referred to as the Reed-Keogh bills, have been introduced into the past few sessions of Congress. This year H.R. 9 was reported favorably by the Ways and Means Committee, but it got no further. England has recently adopted legislation to permit qualified retirement plans for the self-employed. It's an outrage that we do not permit it in this country. I hope the Reed-Keogh bill will be reintroduced and enacted in the next session of Congress. If the Commissioner had not narrowly defined employee, remedial legislation would not be so urgently needed.

Another horrible example is a recent ruling[19] which holds that partners, because they are not employees, are not entitled to exclude sickness benefits under Section 105(d) of the 54 Code. Or take the case of those multi-employer, negotiated welfare trusts which are now receiving income from the investment of accumulated surplus funds. It was commonly thought that such trusts were exempt as voluntary employees' beneficiary associations under Section 501(c)(9). The Commissioner apparently agrees if, but only if, the participating employees do not include self-employed and partners. In the construction trades and many others this is a big "if." Nevertheless, the Commissioner is presently taking the ridiculous position that a substantial number of these welfare trusts are not tax exempt because some of the participants are not "employees."

Finally, we have the situation prevalent among multi-employer, negotiated retirement plans, such as the plan Harry Bridges and the ILWU negotiated with the Pacific Maritime Association in 1951. In the waterfront industry, many

individuals work full time in the industry but are not employees of any one employer; they are, however, covered under the industry plan if they have the required amount of industry service. Employers' contributions to the plan, if they exceed 5% of covered payroll—and they do—are deductible only to the extent that they are in payment of the unfunded past and current service costs. Although Section 404(a)(1)(B) talks in terms of "all of the employees under the trust," the Commissioner initially interpreted the term "employees" to mean the employees of a particular employer, and requested each employer to compute the unfunded cost with respect to his own employees.[20] As a practical matter these costs could only be computed on an industrywide basis. With the deductibility of millions of dollars of employer contributions at stake a special ruling was finally obtained only after lengthy correspondence and conferences in Washington. This ruling permitted each employer to compute and deduct his proportionate share of the total actuarial cost on the basis of his contributions to total contributions. Although a practical, sensible procedure has thus been worked out for the future, the deductibility of past contributions has still not been satisfactorily resolved. All of this fuss and fury because the Commissioner is apparently irrevocably wedded to the technical legalistic definition of employee.

I respectfully submit that the common good would be enhanced and the orderly development of employee benefit plans would be furthered by an interpretation of the term employee based on business and economic facts rather than the niceties of the old English common law. In the employee-benefit-plan field, an employee should be anyone who works. Such a definition should not adversely affect the revenues or open any tax loopholes. It would eliminate the gross unfairness of giving preferred tax treatment to the fringe benefits of some who work while denying it to others.

Prohibited transactions

A literal interpretation of Section 503(c) of the 1954 Code would prevent a qualified trust from investing in the corporate employer's unsecured notes or debentures or the subordinated notes of a partnership employer even though it has always been and still is permissible to invest in the employer's common stock. The crux of the controversy involves a definition of the term "adequate security," for the new law prohibits a qualified plan from lending money to the employer without the receipt of reasonable interest and adequate security.

In January of this year, proposed Regulations were issued which, to the dismay of many employers and consultants, have adopted the literal, narrow interpretation. In Section 1.503(c)-1(b) the term "adequate security" is defined as follows: "Something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan."

In explaining this interpretation of the term, Mr. Isidore Goodman has aptly described it as "pawnshop" security. The examples in the Regulations make it clear that the Treasury interprets "adequate security" to exclude the employer's unsecured notes or debentures or the subordinated notes of a partnership-employer without regard to the financial stability or net worth of the employer. Indeed, a corporate employer's note or debenture secured by sufficient market value of the employer's stock is not adequately secured under this view because the stock is junior to the note or debenture. By the same token, a convertible debenture is said not to be adequately secured, but all the while a direct investment in the employer's stock is permitted.

In keeping with past practice, the Service invited all those interested in the proposed Regulations to express their views at a hearing held in Washington earlier this year. Among those who attended and objected were representatives of American Telephone and Telegraph, Southern Pacific Company, and U. S. Steel Corp. The latter sought changes that would permit its qualified trust to continue to hold the millions of dollars of U. S. Steel debentures which have been part of the trust portfolio for several years. Southern Pacific sought permission to use new but top quality Southern Pacific debentures to fund a good share of its liability under the relatively-new pension plan which it has adopted to supplement the Railroad Retirement System. The Telephone Company, so I am informed, urged with convincing logic, that no loan was involved where its pension trust bought Telephone Company debentures on the open market.

Since these hearings I have heard no word, official or otherwise, as to any change in the Service's position. There are those that take comfort from the fact that final Regulations have not yet been issued. For what it is worth, I would guess that the final Regulations will not be issued this year, and when they are issued, I do not anticipate any substantial change in the proposed interpretation of adequate security. I think this will be a mistake, for I am convinced that Congress did not intend to prevent large, stable companies from investing their pension funds in their own unsecured debentures. I believe it obvious that in 1954 Act Congress desired only to prevent an employer from using his qualified retirement trust as a source of credit where no other credit was available to him. It is hard to urge that a plan is for the exclusive benefit of employees if the employer is allowed to receive preferential credit treatment from the fund. I would also guess that the Treasury will be reluctant to bring a test case, especially if the unsecured debentures are bought on the open market. If they are not issued by the employer directly to the qualified trust, it is difficult to spell out the required loan. Perhaps this will prove to be the practical line of demarcation. If not, legislation will be required. Several bills were introduced in the last Congress, but none were adopted.

Payment of employer contributions

Section 404(a)(6) of the 1954 Code extended the time within which an accrual-basis employer could make a deductible contribution to a qualified plan. If the liability existed at the end of the year, the time for payment was extended from the 60 days permitted under the 1939 Code to the due date of filing the employer's income tax return,

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[13] Rev. Rul. 56-102, IRB 1956-12, 5.
[14] IRB 1956-24, 110.
[15] CCH Pension Plan Guide ¶16,080.
[16] CCH Pension Plan Guide ¶¶16,087-9.
[17] United States v. Kintner, 216 F.2d 418 (9th Cir. 1954).
[18] Rev. Rul. 56-23, IRB 1956-4, 9.
[19] Rev. Rul. 56-326, IRB 1956-29, 10.
[20] Rev. Rul. 55-204, 1955-1 CB 300.

including extensions thereof. Late last year the Service, in an unusual show of liberality, ruled that payment before the due date of the income tax return, but more than 60 days after the end of the taxable year, was deductible even though the qualified plan specifically required payment to be made within the 60-day period.[21]

Another liberal ruling[22] in this field held that a promise under seal could be the corpus of a qualified trust if, under local law, such a promise was binding without other consideration. This is important where the employer, in starting a new plan, forgets to make even a token deposit before the end of the year. Heretofore, the Service has held that the subsequent contribution was not deductible in the original year because there was no trust in existence at the end of that year. This conclusion rests on the principle that you cannot have a trust without a corpus. Although the *Dejay*[23] case has cast some doubt on the legal validity of the reasoning, I for one would not willingly take the gamble. Despite these two liberal revenue rulings and the dicta in the *Dejay* case, I would strongly recommend to every taxpayer that a few dollars be put into a new trust before the end of the year and that new and old trusts and plans be written or amended so that payment is made in accordance with the plan and within the period permitted by law.

Capital gains

Under the 1939 Code, lump-sum distributions were entitled to the capital gains treatment under Section 165(b) only if they were made from a trusteed plan and only if they were made on account of the employee's termination of service. P.S. No. 59[24] held that capital gains treatment was available if the entire balance due was distributed at termination of service even though partial withdrawals from the trust had occurred before termination. In the 1954 Code, insured plans were put on a parity with trusteed plans, and capital gains treatment was extended to lump-sum distributions on death after termination of service.

Controversy has occurred in those cases in which the employee-taxpayer claims and the Commissioner denies that there has been a termination of service or alternatively that the lump-sum distribution was made on account of the employee's termination of service. The *Fry*[25] case supported the Commissioner and denied capital gains treatment on the ground that the employee did not in fact terminate service. In that case the employee retired but continued in the same job after retirement, calling himself an independent contractor. A few months ago, the Service formalized its position in Revenue Ruling 56-214[26] which specifically holds that capital gains treatment is not available if the employee continues to work for his employer. The necessity of an actual termination of service is also apparent in Revenue Ruling 55-298,[27] involving a qualified profit-sharing plan which purchased vested annuities for its participants each year. There was no cash-surrender value to these contracts if termination occurred more than ten years before normal retirement date. Because the plan was qualified, there was no taxable income to the employee on the purchase or delivery of the contract to the employee, but if the contract was cashed within one year of the termination of service, the employee got capital gains; if after a year, it was taxed as ordinary income.

The new law did not clarify whether capital gains treatment applies to the lump-sum distribution made on termination of a qualified plan as the result of a merger where the employee continues to work in the same job for the successor corporation. The Tax Court in the *Glinske*[28] and *Miller*[29] cases reached contrary results on only slightly different facts. A termination of the employee's service was found in *Miller* but not in *Glinske*. Since that time, the *Miller* case has been affirmed by the Sixth Circuit, and very recently the taxpayer won again in the *Martin*[30] case. Following its decision in the *Miller* case, the Tax Court held in the *Martin* case that there was a separation from service where the employer liquidated by transferring all of its assets to its parent corporation which continued the taxpayer in his former job. The Court defined service for this purpose to mean "service with the employer." However, in the *Oliphint*[31] case, which the Tax Court decided late in 1955, the distribution was held to be ordinary income because a change in stock ownership due to reorganization resulting from an antitrust action was not thought to be equal to a termination of service.

In the light of these four cases, and I know of no others, I can only suggest that one should proceed with caution, for the law is very definitely unsettled. More than that, the Service, despite the *Miller* and *Martin* cases, continues to assert that termination of service must be interpreted as termination with the business, not mere termination of the formal corporate entity that is the employer.

[21] Rev. Rul. 55-670, 1955-2 CB 233.
[22] Rev. Rul. 55-640, 1955-2 CB 231.
[23] Dejay Stores v. Ryan, 229 F.2d 867 (2d Cir. 1956).
[24] P-H Pension and Profit Sharing Serv. ¶9558.
[25] Fry's Estate v. Comm'r, 205 F.2d 517 (3d Cir. 1953).
[26] IRB 1956-20, 12.
[27] 1955-1 CB 394.
[28] Edward Joseph Glinske, Jr., 17 TC 562 (1951).
[29] Mary Miller, 22 TC 293 (1954), *affirmed*, 226 F.2d 618 (6th Cir. 1955).
[30] Lester B. Martin, 26 TC No. 9 (Apr. 17, 1956); CCH Dec. 21,678.
[31] Harry K. Oliphint, 24 TC 744 (1955), *affirmed per curiam* (5th Cir. 1956), 56-2 USTC, ¶9676.

New decisions this month

Bell employee sickness plan not taxable; court follows Epmeier. The court follows the Epmeier case and holds benefits under the Bell Telephone Co. employees sickness plan nontaxable, though it was not insured. [Under the 1954 Code, $100 a week is excludable whether the plan is "insurance" or not. *Ed.*] *Pfleiderer*, DC Ind., 7/20/56; *Stanley*, DC Ind., 7/20/56.

Sale at time restricted stock option acquired may be wash sale. A sale is considered a wash sale, and loss thereon is disallowed, if the taxpayer, within 30 days, buys substantially identical securities or enters into an option agreement to buy them. For purposes of determining the applicability of the wash sales provisions, an employee of a corporation who under the terms of a restricted stock option plan is granted an option to purchase stock of the corporation will be held to have entered into the option to acquire stock on the date on which the option is granted. He "acquires" the stock not when he exercises his option by notifying the company, but on the date the stock certificates are issued to him. *Rev. Rul.* 56-452.

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TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

OF INTEREST TO TAX PRACTIONERS

When and how to use the new statutory custodian for gifts to minors

by M. R. SCHLESINGER

As tax men study the possible uses of the new laws being adopted by the states permitting use of a statutory custodian for gifts to minors instead of the more cumbersome trust, it becomes increasingly apparent that the new plan is not necessarily a cure-all, to be used in every case. It has some definite disadvantages as well as the obvious advantages. Here's the way this author approaches the question of when and how to use the statutory custodian.

A UNIFORM ACT, sponsored by the Association of Stock Exchange Firms, has been adopted by several states. That act provides that a gift to a minor may be made to a custodian for that child [see 4 JTAX 298].

The statute's provisions

The new statute is intended to avoid the substantial practical difficulties in the way of selling or otherwise transferring registered securities which have been placed in the name of a minor. The custodian may be any of several adult family members—exactly who it may be is particularized in the statute—and the donor himself is included in this group. If the securities are registered, they must be in the custodian's name, followed by a legend as prescribed in the applicable statute, generally, that the owner is a custodian under the applicable sections. If the gift is of bearer securities, it must be in substantially the form provided by the statute—a deed of gift signed by the donor and the custodian.

The statute provides that the income and principal may be distributed to or for the benefit of the minor. When he reaches 21, however, the accumulated income and the principal must be distributed to him. The gift is irrevocable, and an indefeasible vested interest is obtained by the minor. These provisions respecting the rights and benefits of the minor have been carefully drawn with an apparent eye to taxes. The custodian has broad investment powers. He is not restricted to bonds, to preferreds, or even to a percentage of limited common stocks. He is, however, subject to a "prudent man rule." The successors to the custodian are set out in detail. There is a broad exculpatory provision running to the benefit of persons dealing with anyone in whose name the security is registered as a custodian. You will realize, of course, that that provision will be of particular comfort to transfer agents to whom presumably it is primarily directed.

Important tax questions

This new statute raises important tax questions. To whom will the ordinary income (that is, the dividends and interest) and the capital gains, if any, be taxed? Revenue Ruling 56-86, discussing the gift status of transfers under the Colorado statute, says merely: "The income tax consequences of such a transfer are still under consideration." This ruling held that a gift tax exclusion was allowable for gifts.

When to use a statutory custodian

Now let us turn to the practical question of when you will and when you will not want to use this new statutory-custodianship vehicle.

Obviously, you will want to consider its use only if the gift consists of securities other than Government savings bonds. Even if the gift is of registered securities, however, there are many times when, quite apart from the transfer difficulties, an outright gift to a minor of such securities will not be indicated. Instead, it might be wiser to make a gift pursuant to a full-blown and carefully worked-out trust agreement. The statutory custodianship should not be universally used as the vehicle for gifts of registered securities. It does not provide many advantages.

First, it does not split the income tax burden and the income tax brackets as between a trust estate and the beneficiary. Such splitting is desirable if substantial income is to be derived or if the minor already has substantial income. On the other hand, a carefully-drawn trust agreement, when appropriate, might provide for only one-half of the income to be distributed to the minor and for the balance to be accumulated in trust, or for discretion as to how income should be distributed, or for all the income to be accumulated. The income not distributed to the minor is not piled on top of the minor's other income; it is reported separately by the trustee at the low trust income tax brackets, starting at 20%. By contrast, if the gift is held by a statutory custodianship, it appears likely that *all* of the income will be taxable to the minor.

Second, under the statutory-custodianship form, if a minor dies before 21, the gift property, will be swept into his estate for inheritance and federal estate tax purposes. In a trust under a properly-drawn agreement, you might very well want to provide for remainders over if the minor should predecease the date of distribution to him.

Third, many donors do not wish their minor children to receive the gift property outright as early as 21 years of age.

Fourth, and related to the third, is the fact that some donors do not wish a single-end distribution of gift property to their children. They prefer periodic or driblet distributions, perhaps half at 25 and the balance at 30, or one-third at 25, one-half the balance at 30 and the entire balance at 35.

Fifth, the custodianship statute relates only to gifts of securities; it authorizes the custodian to hold only securities and cash. As a result, it is not a vehicle for holding real estate, whereas a properly-drawn trust agreement can be designed for that purpose. Further-

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more, the trust agreement can be drawn so as to accommodate the possibility of taking out insurance.

Sixth, the custodianship form does not afford the protection of the spendthrift clause.

Finally, the custodianship form is not available for tying in with the parents' and grandparents' testamentary plans. On the other hand, a detailed estate plan frequently involves a living trust agreement for minors, not only to serve as a receptacle for inter vivos gifts but also to serve as a receptacle for probate property and insurance as well. Thus, legacies from the grandparents and parents, as well as insurance on their lives, instead of going into a testamentary trust under a will for the benefit of minors, can be poured over into a living trust agreement, which, if properly drawn, can do triple duty, as it were, serving as a receptacle for gifts, probate property and insurance.

All seven qualifications become more important as the size of the present or the expected future gifts increases. A carefully-drawn trust agreement can combine all seven of those advantages which are lacking in a statutory custodianship. Some of those seven qualifications are almost certain to be important, provided the donor contemplates, in the present or in the future, substantial gifts while the donees are minors.

In general, then, the custodianship form will frequently prove helpful if gifts of securities to minors are contemplated. It should be considered, however, only where, but for the transfer difficulties, a gift outright would have been indicated.

Summary

By way of summary then, here is what we have seen. The custodian form is not appropriate for universal use in making gifts for minors. It does not solve the transfer of real estate difficulties, and it is not appropriate for the holding of partnership interests or for the taking out of and paying for insurance. Even as to registered securities, it fails to do many things, at both the tax and non-tax levels, which only a full-blown trust agreement can do. On the other hand, as a rule of thumb, where registered securities would be placed in the name of a minor but for the transfer difficulties—and this will generally be the situation where the gift is relatively small—in such everyday situations the statutory custodianship will frequently prove to be a useful device. ☆

New estate & gift decisions this month

Reciprocal trust theory not applicable to business cross-insurance. Two stockholders in a closely-held corporation agreed that the survivor would acquire the stock held by the first to die. To finance this obligation, each took out insurance on the life of the other. When one dies, the insurance taken out on his life by the other is not includible in the decedent's gross estate. The only possible ground for inclusion would be by analogy to the reciprocal trust doctrine, *Lehman,* 109 F.2d 99, but the IRS does not extend that doctrine to this situation. Of course, the value of the unmatured policy on the life of the survivor is an asset of decedent's estate and is includible for Federal estate tax purposes. *Rev. Rul.* 56-397.

Estate includes insurance in trust; decedent had incidents of ownership. In a brief memorandum opinion which does not detail the facts, the court holds that taxpayer had not only a reversionary interest worth less than 5% of the value of the insurance but that it also had the incidents of ownership. Had the decedent's only interest been the reversion, the policies would not be includible in his estate, but the incidents of ownership made them taxable. *Willing Estate,* DC Ill., 5/2/56.

Relief law, validating subsequently overturned Regulation, validates unfavorable parts too. This estate is the one in which the Supreme Court held a trust includible because the decedent had a possibility of reverter. The 1951 Revenue Act subsequently provided that in estates of persons dying between 1937 and 1938 the Regulations then in force should apply. Although this would exclude the trust on the possibility-of-reverter theory, declared nontaxable by those Regulations, the court here finds the trust includible because the decedent had a contingent power to terminate the trust which the Regulations then in effect provided would cause the trust to be included in the state. *Field,* DC NY, 7/18/56.

Outright payment to widow as dower is marital deduction. Generally, dower is a life estate, and thus a terminable interest not qualifying for the marital deduction. Under Alabama law, however, if the personal estate is insufficient, the widow may consent to the sale of the realty and the payment of her dower out of the proceeds. In this case, the widow consented to the sale of realty having a value of $1,641,000, and she received $547,000 outright as her one-third dower interest. This amount received by the widow qualifies for the marital deduction. *Crosby Estate,* DC Fla., 7/2/56.

Attorney fees allocated between estate expense and administration. Allocating a portion of the attorney's fee paid by the estate to the termination of joint tenancies, which it was stipulated were not deductible, the court finds the remainder is a reasonable administration expense and deductible. Adjustment is made for disallowances of executor's fees claimed on the return but subsequently waived. *Mitchell Estate,* DC Calif., 6/20/56.

Funds seized by Alien Property Custodian and held by Treasurer are not exempt from estate tax. The estate of a nonresident alien not engaged in business here pays estate tax on U. S. assets; there is, however, an exemption for deposits in U. S. banks. This decedent, a nonresident alien not engaged in business in the U. S., owned certain funds seized by the Alien Property Custodian. These funds were deposited with the Treasurer of the U. S. for account of the Property Custodian. Since the Treasurer of the U. S. is not a person "carrying on the banking business," the funds are not within the exemption for deposits with such persons. Accordingly, the funds are subject to federal estate tax. *Rev. Rul.* 56-421.

Power of appointment "exercised" though distribution of property not

affected. Decedent held a general power of appointment over a trust established by her grandfather's will in 1894. Decedent's will left all her property to her sons, who were also the takers in default of appointment under the grandfather's will. Nevertheless, this was an exercise of the power of appointment by decedent under applicable Pennsylvania law, even though the power was not specifically referred to and the will did not affect the distribution of the property. For powers created prior to 1942, possession and exercise are necessary to make the property taxable in the holder's estate. Since decedent exercised a pre-1942 power, the value of the trust property is included in her gross estate. [For powers created after 1942, possession of a general power makes the property taxable in the holder's estate. *Ed.*] *Sands Estate* (Keating, Ex'r), CA-3, 9/7/56.

Court uses actual life, not mortality tables of Regulations. At age 72, decedent and her two adult children created a trust with income to decedent for life and remainder to the two children in equal shares. Decedent contributed $165,000 to the trust; each child contributed $142,000. On the basis of the mortality tables in the Regulations, decedent had a life expectancy of seven years, and the value of her life interest, when the trust was created, was much less than the $165,000 value of the property she transferred. In fact, decedent lived nearly 14 years and recovered more than she transferred. The court holds that use of the table is not binding; it quotes the Regulations that "all relevant facts . . . as of the applicable valuation date shall be considered. It notes that the mortality tables outmoded the current ones which figure the expectancy at 13.8 years. It therefore uses the actual fact of decedent's longevity, saying "no better evidence of the life expectancy of a person can be had than the actual length of time that person lived after that date." The court holds that the transfer with a retained life estate was for a full consideration, and thus not includible in the estate. It also declines to give conclusive effect to the fact that decedent had reported the transaction as a gift. *Nourse Estate,* DC Calif., 8/22/56.

Didn't prove decedent wasn't owner of property put in trust; it is taxable in her estate. Decedent was the nominal grantor of a trust with such power to alter the beneficial interests as would require inclusion in her gross estate. The estate argued, however, that she was not the real owner of the corpus but that the trust was established out of her husband's estate, of which she was principal beneficiary, to compromise a will contest. Finding only a mere threat of a contest, the court holds that the estate has failed to carry the burden of proof that the decedent never acquired ownership of the assets. *Bailey Estate,* DC NY, 8/14/56.

Legacy to California Alumni Association deductible from gross estate. [*Acquiescence*] Court held deductible a legacy to the California Alumni Association, though its activities were in some part social and recreational, not educational. The majority found these activities incidental and that the Association operated exclusively for educational and charitable purposes. One dissent on the ground that the social and recreational activities of the Association were in fact substantial. *Thayer Estate,* 24 TC No. 42, *acq.* IRB 1956-37.

Court computes charitable remainder after annuities. [*Acquiescence*] Income of a trust created under this will is to pay certain annuities; for others corpus may be invaded. $25,000 would be payable to decedent's widow on remarriage, when her income would cease. The court assumed a 4% return on corpus, deducted the $25,000, not being certain the amount would not go to the widow. In computing her annuity, the court used remarriage tables. The date-of-death value of the balance after all these charges is the amount deductible. *Alexander Estate,* 25 TC 600 *acq.,* IRB 1956-37.

Exclusions allowed; interests in trust valued despite power of invasion. [*Acquiescence*] Taxpayer created a trust with income to his wife and remainder to others. The trustee was given power to invade principal for the benefit of the wife, with due regard to her other sources of funds. The Commissioner argued that no exclusions were allowable because the amount of gift to the various parties could not be determined. Considering the wife's living habits, her own property, and her husband's earning capacity, the court was able to find a reasonable standard for valuing this power of invasion. Since a value could be fixed for the gift to the wife of the current income plus the possibility of invasion of principal in her favor, this gift was entitled to the $3,000 annual exclusion. The remainder interests to third persons thus could also be valued, and splitting of the gifts, between husband and wife, was permissible. *Robertson,* 26 TC No. 29, *acq.* IRB 1956-37.

Can't split gift to sprinkling trust; wife is possible beneficiary. A donor created a "sprinkling" trust with discretionary power in the trustee to distribute income or principal among the donor's wife or children. The Service holds that because the value of the gift to the wife is uncertain, no part of the property so transferred in trust can be taxed as a gift between spouses. Likewise, the value of the gift to the children is indeterminate and cannot be taxed as made half by each spouse. *Rev. Rul.* 56-439.

Trustee had powers of guardian; gifts to minors were present interests. Taxpayer made gifts in trust for various minor grandchildren. The trustee was given powers as extensive as those of a guardian, but was not required to account to a court. Each trust was to terminate upon the beneficiary's reaching age 21, and if the beneficiary died before reaching that age, the corpus would be part of his estate. The court holds that the interest given for the beneficiary were present interests, entitled to a $3,000 gift tax exclusion. [1954 Code Section 2503 specifically allows tn exclusion if corpus and income may be expended for the minor before attaining 21, the unspent portion to go to him at 21 or his estate if he does not survive. *Ed.*] *Baker,* CA-4, 8/15/56.

Gifs of stock of U. S. corporations by nonresident aliens not taxable. Nonresident aliens not engaged in business here are subject to tax on gifts of U. S. property. The Service holds that although stock of a dometsic corporation has a situs in the U. S., gifts of such stock by these nonresident aliens are not subject to gift tax. Section 2501 of the 1954 Code specifically exempts gifts of intangibles by such nonresident aliens. *Rev. Rul.* 56-438.

Notes on new estate and gift decisions in this department are by Theodore Berger, LL.B., CPA, who practices in Chicago.

THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

Courts are still final arbiter of what travel expenses are deductible; beware hysteria

by MELVIN ORENSTEIN

Frequent intimations during recent months that the Commissioner is "cracking down" on personal travel deductions is causing uneasiness among many taxpayers, and even among some tax men. While it is true that IRS administration does seem to be tightening up on such things as good records, proof and justification for expenditures in order to allow deductions, tax men should not because of this forget that it's the courts, not IRS administrative policy, that make the final rules. This article is an analysis of court decisions considered to be currently important in determining whether a given travel expense is deductible. It is a solid antidote for the hysterical client who has been reading the papers.

TRAVEL EXPENSES paid by an individual are sought to be deducted for tax purposes in four or five principal situations. The rules evolving from current court decisions vary from one situation to another. In order to assess the importance of these decisions in an orderly manner, the following analysis is classified according to the type of travel involved.[1]

Commuting not a business expense

Commuting, i.e., traveling between residence and business, is a personal living expense and not a business expense. Deductions have been disallowed for such expenses even when the taxpayer was paralyzed or physically incapacitated and had to use a car,[2] when no public transportation was available,[3] when late working hours prevented train connections and a car had to be used,[4] or where taxpayers lived at the job site and commuted to see their families.[5] Commuting expenses are not deductible even though they are somewhat related to the occupation or production of income,[6] or even where tools are transported in the car, regardless of the distance traveled.[7] Expenses incurred in moving to another locality to accept new employment[8] or when being transferred to another station of permanent duty[9] are likewise nondeductible, except that in the latter case reimbursement by the employer of such expenses must be included in the employee's gross income only to the extent it exceeds the actual cost of moving. The requirements which the travel expense must meet to be deductible were aptly expressed in the *Flowers* case, decided by the United States Supreme Court in 1946.[10]

The Flowers case

The *Flowers* case involved an attorney who resided with his family in Jackson, Mississippi. His sole occupation, during the taxable years in question, consisted of representing, as general solicitor, the Gulf, Mobile and Ohio Railroad, whose main offices were in Mobile, Alabama. Although the taxpayer could have performed all his services in Mobile, he arranged to perform his duties in both Mobile and Jackson, since he did not wish to move from his home town where he was both socially and professionally established. The taxpayer deducted the cost of trips to Mobile, as well as the expenses of meals and accomodations there. In reversing a Fifth Circuit judgment in favor of the taxpayer, and disallowing the deduction, the Supreme Court formulated three tests which must be met in order to render the travel expenses deductible:

1. The expense must be a *reasonable and necessary* traveling expense as that term is generally understood. This includes such items as transportation, fares, food and lodging expenses incurred while traveling.

2. The expense must be incurred *while away from home.*

3. The expense must be incurred *in the pursuit of business.* This means there must be a direct connection between the expenditure and the carrying on of the trade or business. . . . Moreover, such an expenditure must be appropriate to the pursuit or development of the business or trade . . .[11]

The Commissioner in the *Flowers* case contended that (1) "home" referred to the main post of business (Mobile); and (2) the expense was not incurred in the pursuit of business.

For the past 25 years or so, the majority of cases[12] boldly stated that "home, for the purpose of the travel-expense sections, means chief post of business," in spite of occasional attacks on that doctrine.[13] The majority *Flowers* opinion pointed out[14] that administrative rulings have consistently defined home as the chief post of business, and that the taxpayer will have to overcome the presumption of correctness of these rulings. Mr. Justice Rutledge, in his dissent to the majority opinion, contended that home means what it does in its popular meaning, and that long-distance irregular travel should not be included among personal living expenses.

The majority opinion, which thus seemed to approve of the Commissioner's definition of home, went on to say that

[1] An earlier article on travel deduction by this writer appeared in 11 NYU INTRAMURAL LAW REV. 280 (1956).
[2] John C. Bruton, 9 TC 882 (1947); Esther E. Ranstead, 10 TCM 117 (1951).
[3] Edmond A. McMorriss, 10 TCM 518 (1951).
[4] John S. Martin, 3 TCM 626 (1944).
[5] Ford v. Comm'r, 227 F2d 297 (4th Cir 1955); Beatrice H. Albert, 13 TC 129 (1949).
[6] Ralph D. Hubbart, 4 TC 121 (1944).
[7] Rev. Rul. 56-25, IRB 1956-5, 9; Edmond A. McMorriss, 10 TCM 518 (1951).
[8] William C. Byers, 14 TCM 153 (1955).
[9] Rev. Rul. 54-429, IRB 1954-40, 15.
[10] Comm'r v. Flowers, 326 US 465 (1946), reversing 148 F2d 163 (5th Cir 1946).
[11] *Id.* at 470.
[12] William W. Todd, 10 TC 655 (1948); John Henry Chapman, 9 TC 619 (1947); George W. Lindsay, 34 BTA 840 (1936); Charles E. Duncan, 17 BTA 1088 (1929); Mort L. Bixler, 5 BTA 1181 (1927).
[13] Wallace v. Comm'r, 144 F2d 407 (9th Cir (1944); Joseph H. Sherman, 16 TC 332 (1951); Harry F. Shurer, 3 TC 544 (1944); see also the *Flowers* decision by the Court of Appeals for the Fifth Circuit cited in note 10 *supra.*
[14] Citing OD 1021, 5 CB 174 (1921); IT 1246, 1-1 CB 122 (1922); IT 3314, 1939-2 CB 152; GCM 23672, 1943 CB 66.

the case was decided on the basis of a Fourth Circuit opinion,[14a] which disallowed the deduction under similar circumstances on the ground that the maintenance of the actual residence at a distance from the job was due not to business exigencies, but solely to the taxpayer's pattern of life and for his convenience. The trips to the taxpayer's main post of duty were therefore, not in pursuit of the business, since they added nothing to the value of his services to his employer. There was thus no need to rule directly on the validity of the Commissioner's definition, since the case was disposed of on the ground of failure to satisfy the third condition of the formulated test.

Since the *Flowers* decision, lower courts have tried to apply the three tests to other fact situations,[15] and the Commissioner has adopted them in his Regulations and Rulings.[16] Deductions have been disallowed even where there were no living accomodations available for the taxpayer's family at or near the job site[17] or where the taxpayer was not allowed to bring his family to the job site.[18] The Commissioner defines home as chief post of business,[19] and the definition is sustained by the overwhelming majority of cases decided recently.[20] A recent Revenue Service publication[21] defines home as: "the place of business, employment station, or post of duty, regardless of residence . . . not limited to a particular building or property but including the entire city or general area where the business premises are located."

Difficulties have arisen in applying the *Flowers* tests to situations involving taxpayers who held two or more jobs at the same time, had jobs of temporary or indefinite duration, had no settled home (residence or business), or had occupations requiring travel.

The double-business doctrine

A 1954 Revenue Ruling[22] states that, although the tax home for the purpose of deduction is normally the place where the taxpayer conducts his trade or business, in cases where he is engaged in two or more separate localities, the tax home is located at the principal post of duty during the taxable year. Travel expenses and food and lodging during the period away from home may be deducted in such cases. Furthermore, where the minor post of business coincides with the taxpayer's residence, expenses attributable to his stay there in pursuit of the minor business are deductible. Such factors as the total time spent at each post, the degree of business activity and the financial return obtained at each point are weighed in the determination of the chief post of business. Although none of these factors are determinative, singly, great weight will be given to the degree of financial return where all the services are performed as an employee.[23]

A 1955 Revenue Ruling cites the following example:[24] Taxpayer was asked to work four days a week in City Y and one day per week in City X (100 miles distant from City Y) where taxpayer's residence was located. City Y is taxpayer's tax home, and he may deduct travel expenses to City X and the costs of meals and lodging attributable to him at X for one day while on business, even if he stays at his residence.

The double-business doctrine has been more or less consistently applied by the courts.[25] It must be noted, however, that the taxpayer must claim his deduction at the minor business post. In two cases[26] where the taxpayer claimed his expenses at the place which the court found to be his main post, and no alternative deductions were claimed at the place which consequently became the minor post, no deduction at all was permitted.

The third condition of the *Flowers* case states that the trip must be undertaken for the exigencies of business. If this test is applied to each of the separate employments or businesses of the taxpayer, it may be argued that the trip to the minor business adds nothing whatsoever to the taxpayer's services there, but that it is the result of his pattern of life and convenience. Such reasoning could well destroy the deduction afforded by the double-business doctrine. It would seem only just to consider not the individual businesses, but the over-all "big picture" of the taxpayer's total business. When viewed in this light, the trips become necessary travel undertaken for the exigencies of the taxpayer's total business, and they allow him to effectuate the purposes of his over-all business activities. He is thus, practically, in the same position as if he had a single job and was required to travel in the course of his employment. Since the Commissioner contends that the major business post is the taxpayer's tax home, trips to the minor post would clearly constitute "travel away from home."

An interesting question was posed in a case[27] which involved a husband and wife who worked in different localities. The court decided that the couple did not form an economic unit as to create the tax home at the chief post of business of either one of them, and that each spouse must base the deduction on his (or her) individual chief post of business. Evidently the court felt that the total picture of the taxpayer's total business was not big enough to include the business of the other spouse, and it rightly refused to extend the double-business doctrine to cover this situation.

Temporary and indefinite jobs

Where taxpayers have held temporary jobs, deductions were allowed for the cost of travel to and from the job, and the cost of meals and lodging while at the job.[28] The *Shurer* case is an example.[29] The taxpayer, a journeyman plumber, agreed, when a heavy demand for plumbers existed during the war, to work at soldiers' cantonments. He worked for three weeks at Indiantown Gap, Pennsylvania, for nine weeks at Aberdeen, Maryland, and then for 33 weeks at Morgantown, West Virginia. The Court observed that these were a series of temporary assignments, since the taxpayer was a specialist requiring a short and reasonably fixed amount of time to do his specialized job at each location. The court further observed that the taxpayer registered yearly as a plumber in Pittsburgh, belonged to a union local there, looked to the local for employment, and returned home and reported to the local after each assignment. Other examples of temporary jobs include cases where a temporary business trip was somewhat extended because of business conditions;[30] where an actor who had business offices in New York

[14a] Barnhill v. Comm'r, 148 F2d 913 (4th Cir 1945).
[15] See, e.g., Amoroso v. Comm'r, 193 F2d 583 (1st Cir 1952).
[16] Reg 118, §39.22(a)-2(a), (h), and (g) (1951).
[17] Willard S. Jones, 13 TC 880 (1949) (Oak Ridge, Tenn.).
[18] James R. Whittaker, 24 TC No 86 (1955) (Thule, Greenland).
[19] All of the Commissioner's Rulings on the subject contain or imply this definition.
[20] Fisher v. Comm'r, 230 F2d 79 (7th Cir 1956); Ford v. Comm'r, 227 F2d 297 (4th Cir 1955); Hammond v. Comm'r, 213 F2d 44 (5th Cir 1954); Amoroso v. Comm'r, 193 F2d 583 (1st Cir 1952).
[21] IRS Publication No. 300 (1956).
[22] Rev Rul 54-497, 1954-2 CB 75.
[23] Rev Rul 54-147, 1954-1 CB 51.
[24] Rev Rul 55-604, IRB 1955-40, 8.
[25] See, e.g., Chandler v. Comm'r, 226 F2d 467 (1st Cir 1955).
[26] S.M.R. O'Hara, 6 TC 841 (1946); Robert F. Green, 6 TC 656 (1946).
[27] Hammond v. Comm'r, 213 F2d 44 (5th Cir 1954).
[28] Coburn v. Comm'r, 138 F2d 763 (2d Cir 1943); Harry F. Shurer, 3 TC 544 (1944).
[29] Harry F. Shurer, note 28 *supra;* see also Albert A. Loden, 15 TCM 134 (1956).

obtained a temporary acting engagement in Hollywood;[31] and where an actress' relations with Hollywood were "casual, professional and temporary."[32]

In one case, taxpayer worked six months in each of three years as secretary for the Wilmington, Delaware racetrack; the balance of the year she worked as a secretary in New York.[33] Her husband was employed in New York, where they maintained a common residence. Although the court permitted the deduction of the Wilmington expenses under the double-business doctrine,[34] because this was a case of several occupations undertaken at different times in several places, it seems to partake rather of elements of a temporary employment situation.

A distinction is drawn between temporary jobs and jobs of indefinite duration. In the *Carroll* case,[35] the taxpayer, a Department of the Army employee acting as economic adviser to the Korean Government, claimed to be stationed there temporarily on account of local conditions. The court, in disallowing the deduction, noted that a temporary job is one whose termination can easily be foreseen. Other courts followed this reasoning in cases involving temporary jobs which later became indefinite,[36] overseas government assignments,[37] employment as substitute store manager during the manager's service in the Navy,[38] and service as Secretary of State of Pennsylvania at the pleasure of the Governor.[39] The difficulty of applying the distinction between temporary and indefinite jobs was demonstrated in a recent Tax Court case[40] where the court observed that, on all the facts, the case was "nearer to the *Shurer* case than to the *Carroll* case."

A Revenue Ruling dealing with travel deductions of railroad employees,[41] and a letter from the Commissioner dealing with deductions of nonitinerant construction workers,[42] reveal the Commissioner's views on the subject. In the Ruling, the Commissioner observes that, although taxpayers shifting from one indefinite business to another will have a shift of tax home, persons away on jobs for temporary periods are on travel status during that period. Typical examples of temporary assignments are replacement or relief jobs during sick leaves of regular personnel. In addition, a trainman assigned to one major and one minor seasonal job, regularly recurring every year, may deduct the travel expense at the minor job. In this last situation the minor seasonal job is considered to be of reasonably short and fixed duration during each taxable year.[43] The letter regarding construction workers states that where employment is temporary and widely scattered so that there is no particular city or reasonably-confined area where the taxpayer usually works, then such factors as the worker's residence, the place where he makes his employment contacts, and the locality to which he returns at the termination of employment shall determine his "business headquarters" which constitutes his tax home. Itinerant construction workers, however, who move from job to job without any fixed abode, have a tax home wherever they work.

Although, if the third condition of the *Flowers* case test is applied to each job held by the taxpayer, the travel deduction would not be granted in a temporary-employment case, it is believed that the logical and practical considerations outlined in connection with the double-business doctrine apply with equal force to the temporary-job cases, and that the deduction should be justly allowed.

No settled home; special occupations

The second requirement of the *Flowers* case test is that the travel must be away from home. Both the double-business doctrine and the temporary-job rule depend on the existence of a tax home which is the point from which the travel expense deduction is computed. A difficult issue is presented where the taxpayer has no settled home to serve as his tax home, so that the travel can never be said to be away from home.

The *Duncan* case clearly illustrates the problem. The taxpayer was a traveling salesman who was on the road during the entire taxable year in question, and spent his time in hotels along the way. The court disallowed the cost of his meals and lodging because the taxpayer failed to introduce evidence on the issue of home, and failed to meet his burden of proof on that issue. The taxpayer was allowed to deduct only the cost of rail fares, telephone calls and entertainment, which, the court felt, were costs in excess of ordinary expenses the taxpayer would have had, no matter what his business.[44]

The opposite result was reached in the *Gustafson* case,[45] which involved an almost identical fact pattern, except that Gustafson kept his clothes at the home of his sister and stayed at his sister's home during several weekends. The taxpayer did not share in the expenses of his sister's home. The court allowed the deduction of the entire cost of taxpayer's meals and lodging, and stated that there was no Congressional indication that the taxpayer could not deduct all his expenses away from home even though he had no expenses there.

The *Duncan* case principle was followed in a 1954 Tax Court case,[46] and in a 1956 case decided by the Seventh Circuit.[47] In both cases, the taxpayers introduced proof that they had lived, for some time at least, in the place they claimed as home, had used it as a mailing address, had some of their effects there, etc. It seems likely that the courts were not as liberal about the sufficiency of proof on the issue of home as they were in the *Gustafson* case. But it is believed that, although the *Duncan* case is logically correct in stating that taxpayers who have no home can be allowed no deduction, for their home is wherever they work, and that the *Gustafson* case allowed a too liberal interpretation of "home," the practical aspects of the problem call for another solution. Home should be defined in such a way that the resulting deduction will fairly reflect expenses of travel due to exigencies of business. Tax home might thus be defined as a place or series of places in a general neighborhood, where the taxpayer spends an appreciable period of time during the taxable year, and to which his business is in some way connected.

Occupations which by their nature require travel have been the subject of Revenue Rulings. Among occupations considered were those of baseball players, trainmen, and members of active military reserves.[48] The Rulings on the subject have been very illuminating on many facts of the travel-expense deduction in general. It should be noted,

[30] Chester D. Griessemer, 10 BTA 386 (1928).
[31] Coburn v. Comm'r, note 28 *supra*.
[32] Wallace v. Comm'r, 144 F2d 407 (9th Cir 1944).
[33] Helen E. Stairwalt, 11 TCM 902 (1952).
[34] Citing Joseph H. Sherman, 16 TC 332 (1951).
[35] Michael J. Carroll, 20 TC 382 (1953).
[36] Edward W. Matthews, 14 TCM 198 (1955); Arnold P. Bark, 6 TC 851 (1946).
[37] Michael J. Carroll, 20 TC 382 (1953).
[38] John D. Johnson, 8 TC 303 (1947).
[39] S.M.R. O'Hara, 6 TC 841 (1946).
[40] Robert K. Denning, 14 TCM 838 (1955).
[41] Rev Rul 54-497, 1954-2 CB 75.
[42] Letter from the Commissioner dated May 4, 1956 to Rep. Robert Mollohan (W. Va.); the letter states that a Special Ruling on this matter will be forthcoming shortly.
[43] This situation is somewhat analogous to the *Stairwalt* case; see note 33 *supra*.
[44] Charles E. Duncan, 17 BTA 1088 (1929), aff'd, 47 F2d 1082 (2d Cir 1931).

however, that each case must be judged on its individual merits.

Time and distance requirements

It should be noted that the business or professional man who carries on his business as an individual proprietor claims travel as an ordinary and necessary expense. So long as the expense is not personal (e.g., vacation or commuting), he takes the entire amount. It is only the employee who is concerned with proving that travel, meals and lodging were "while away from home."[49] Taxpayers—both employees and entrepeneurs—who itemize deductions are worried about satisfying the requirements only if they wish to include, among their deductible expenses, the full cost of meals and lodging while traveling, because their transportation costs and possibly some part of their food and lodging costs may be deductible under the general provision of Section 162(a) without reference to Section 162(a)(2).

Can a taxpayer deduct expenses for travel away from home if he returns the same day? In the *Waters* case[50] the taxpayer had to undertake trips of thirty-four miles each weekend in order to confer with his employer. He always returned home on the same day he left. The Commissioner contended that these trips were not overnight and therefore did not constitute travel away from home. The court allowed the deduction, the majority stating that travel away from home has its popular meaning, and that the case in question should not be equated with the case of a trucker or railroad employee on a short haul. The majority pointed out that extra services were involved, and that travel was not an inherent part of the work. Judge Opper, in his dissenting opinion, disagreed with the majority definition of travel; he contended that the case involved transportation, and not travel in its technical sense.[51]

The principle of the *Waters* case was reaffirmed by the *Podems* decision,[52] as well as by a First Circuit case[53] which stated that the court does not believe that Congress intended that trips should be overnight. The court observed that it would be absurd to say that an employee who flies from Boston to Washington on business and returns on the same day is not entitled to the deduction, but that if he takes two days for the whole trip, he is entitled to the deduction.

A recent Revenue publication[54] stated that an overnight trip was required to constitute travel, and defined overnight as a period substantially longer than an ordinary day's work and of sufficient length to necessitate relief to obtain sleep—not necessarily 24 hours or from dusk to dawn, but to obtain necessary sleep, not merely to rest or obtain a meal. While the above definition may well apply to truckers and trainmen on short hauls, it does not seem very logical to apply it to distant travel on business in these days of rapid transit, as the quoted First Circuit case demonstrates.

In order to constitute travel away from home, the trip must extend at least outside of city limits. In a case where the taxpayer's home was adjudged to be in the Greater Boston area, and the taxpayer was a manufacturer's representative within Greater Boston, the deduction was not allowed for travel within that area.[55] Similarly, deduction for travel within his home city was disallowed an insurance salesman.[56] In one case, it is stated that travel must extend not only outside city, but also outside county limits,[57] but this view is not borne out by two more recent cases.[58] It should be noted that transportation deductions to employees computing adjusted gross income, under the 1954 Code, will serve to eliminate much of the times and distance-requirement problems discussed above.

Some taxpayers have sought a deduction under the travel-expense sections for the expense of a meal while working overtime or working inconvenient hours.[59] These deductions were rightly disallowed because, it was pointed out, the taxpayer would have had to consume a meal in the middle of the day in

THE TRAVEL EXPENSE DEDUCTION AND THE INTERNAL REVENUE CODE

Sections 62 and 162 of the Code provide for the deduction of travel expenses as business deductions as follows:

. SECTION 62 ADJUSTED GROSS INCOME DEFINED: . . . the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) TRADE AND BUSINESS DEDUCTIONS.—The deductions allowed by this chapter . . . which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

(2) TRADE AND BUSINESS EXPENSES OF EMPLOYEES.

(B) EXPENSES OF TRAVEL AWAY FROM HOME. — The deductions allowed . . . consist of expenses of travel, meals, and lodging while away from home, paid or incurred by the taxpayer in connection with the performance by him of services as an employee.

SECTION 162 TRADE OR BUSINESS EXPENSES: (a) IN GENERAL—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in pursuit of a trade or business."

Taxpayers who travel under a reimbursement or expense-allowance arrangement with the employer are concerned with the travel-expense deduction. They must include the full amount of reimbursement in their gross income, and then subtract the deductible expenditures. Taxpayers claiming the standard deduction will subtract deductible travel expenses during their computation of their adjusted gross income.

The 1939 Code had basically the same definition of a business expense as the present Code. Cases interpreting earlier statutes are therefore useful aids in interpreting provisions presently in effect.

[45] Charles G. Gustafson, 3 TC 998 (1944).
[46] Nat Lewis, 13 TCM 1167 (1954).
[47] Fisher v. Comm'r, 230 F2d 79 (7th Cir 1956).
[48] Rev Rul 54-147, 1954-1 CB 51; Rev Ruls 54-497, 1954-2 CB 75; 55-109, IRB 1955-9, 14.
[49] IRC §§62(a)(B) and 162(a)(2) (1954).
[50] Kenneth Waters, 12 TC 414 (1949.
[51] *Id.* at 417 (dissent).
[52] Horace E. Podems, 24 TC 21 (1955).
[53] Chandler v. Comm'r, 226 F2d 467 (1st Cir 1955).
[54] IRS Publication No. 300 (1956).
[55] Amoroso v. Comm'r, 193 F2d 583 (1st Cir 1952).
[56] Raymond E. Kershner, 14 TC 168 (1950).
[57] *Ibid.*
[58] Frank N. Smith, 21 TC 991 (1954); Horace E. Podems, note 52 *supra.*
[59] Louis Drill, 8 TC 902 (1947); Fred Marion Osten, 14 TC 1261 (1950).
[60] See notes 50 and 55 *supra.*
[61] Rev Rul 56-49, IRB 1956-8, 6.

a restaurant if his working hours had been regular. Similarly, where the trips were not overnight and the taxpayer did not claim the expense of the meal consumed, the court implied that, if claimed, these expenses might have been disallowed.[60] A 1956 Revenue Ruling[61] states that the meals of a fireman, even if he is stationed for a 24-hour shift in the fire house, are not deductible as travel expenses.

Conclusion

Many important questions have yet to be answered with respect to the travel-expense deduction; the law in this field is still in a state of flux. New cases, and new Rulings will cover particular situations. But much remains to be settled before the law on the subject crystallizes into well-defined, reasonably-precise rules and regulations. ☆

Joint venture to develop patents brings tax savings

UNDER THE 1954 CODE and the proposed Regulations, unusual tax advantages accrue to the high-income taxpayer who backs the development of a patent. By forming a joint venture or a partnership with an inventor who lacks capital, he obtains two advantages. First, he can deduct all experimental losses, and research expenses up to the amount of his investment. Second, if the venture succeeds in developing a valuable patent, he can dispose of his interests at capital gain rates.

To obtain this happy result, he needs merely to become a party to a joint venture or partnership agreement which provides that: (1) he will bear all losses and expenses of the venture; (2) the partners will divide all profits evenly; and (3) developed patents will be owned equally.

Under such an agreement, he, the inventor, or both, can sell their interests in the patent and secure a capital gain. Lump-sum payments and payments according to use of production qualify for this treatment. Moreover, the venture can be engaged in the business of making inventions or in the business of buying and selling patents.

He needs to be careful of only two qualifying provisions. He cannot obtain this capital gain treatment if the patent is acquired after the joint invention has been reduced to practice. And the joint venture must be with an individual inventor. The special capital gain treatment is available only to individuals. ☆

New decisions affecting individuals

Separation agreement revised after August 16, 1954 is "executed" under 1954 Code. If a separation agreement not incident to a court decree is materially revised after August 16, 1954, the Service holds it will constitute an agreement executed under the 1954 Code which treats payments under a separation agreement as alimony. Periodic payments thereunder will be deductible by the husband and includible in the wife's income. *Rev. Rul.* 56-418.

"Support" does not include cost of car. Although transportation is an element of support, the purchase price of an automobile is not to be taken into account in determining who furnished more than half the support of a dependent. *Rev. Rul.* 56-399.

Father fails to prove support of children living with ex-wife. Taxpayer, a father, is denied dependency exemptions for his two minor children living with his divorced wife. He failed to show that he contributed anything toward the children's support. The mother and her second husband testified that they contributed not less than $1000 toward the support of each child. *Pence,* TCM 1956-190.

Diaries used to support salesman's entertainment expenses. A securities salesman who traveled often on business and had frequent occasion to entertain kept diaries in which he made contemporaneous entries of meals and entertainment expenses incurred. The court concludes the Commissioner was not justified in his disallowance of the claimed expenses, but it makes some adjustments for a portion of the charges which were personal in nature. *Jacquemot,* TCM 1956-198.

Can deduct legal fee for pre-divorce settlement of property providing 95% of income. In 1934, taxpayer and his wife agreed to divide their community property into separate property. In 1951, taxpayer incurred legal fees of $10,000 in reducing this oral agreement to writing. The court allows the deduction as incurred for protection of income-producing property, despite the fact that the taxpayer was divorced shortly thereafter. The divorce was not contemplated when the written agreement was made. *Aller,* DC Calif., 8/20/56.

Army man not domiciled in Belgium; can't use community system. Taxpayer claimed that since he was domiciled in Belgium in 1945-1947, he was subject to its community-property laws. The court finds that he did not prove a change from his Tennessee domicile. He was in Belgium as a member or employee of the Army and kept his U.S. ties. *Byers,* Ct. Cl., 7/12/56.

Can't reduce estimated tax penalties by operating loss carryback. The court upholds the propriety of additions to tax for failure to file a declaration of estimated tax and the concurrent imposition of the penalty for substantial underestimation. The base for both computations was the correct tax shown on the final return without adjustment for any net operating loss carryback. *Rictor,* 26 TC No. 115.

Ten-year income from rentals may qualify wife for retirement income credit. If a wife over 65 has rental property and if her personal services as well as capital are material income-producing factors in the rental of the property, an amount not in excess of 30% of the net rentals computed for each year represents earned income for the purpose of determining her eligibility for the retirement income credit. [The Code defines earned income from a trade or business requiring both capital and personal service shall be a reasonable allowance for services, not in excess of 30% of net. *Ed.*] She may not use her husband's earned income as her own for such purposes. Interest and rental income reduced by the amount allocable to earned income under the 30% rule constitute her retirement income. *Rev. Rul.* 56-416.

Child-adoption expenses not deductible. No part of the expenses, such as doctor, hospital, legal or agency fees, paid in connection with child adoption are deductible as a medical expense or charitable contribution. *Rev. Rul.* 56-401.

MANAGEMENT OF THE

Professional tax practice

AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

New Agran decision says CPA practiced law; Treasury interpretation ignored

THE FINAL appellate opinion in the *Agran* case was handed down on September 20. It upheld the same court's previous opinion that Reuben Agran had been guilty of the illegal practice of law in handling a tax matter for a client before the Treasury Department. Thus ends this phase of a long-litigated, expensive, and troublesome contest over what professional qualifications are required to represent clients in tax matters before the Treasury Department.

It happened this way. Agran, a Los Angeles CPA enrolled to practice before the Treasury, represented a client in a tax matter with a revenue agent, and obtained a closing satisfactory to the client. Client refused to pay his fee; Agran sued. In the trial court Agran won. Client appealed, argued that Agran had practiced law illegally. Client won on appeal, and the case was remanded for determination of what part of the work done was legal; this part of the work could not be collected for. The trial court determined that the legal work was one half. Agran then appealed in the present proceeding. (JTAX, 7/54, p. 29).

After the first appeal had been argued, the State Bar of California entered the case as amicus curiae in general support of the plaintiff and the California Society of CPAs did likewise on behalf of Mr. Agran. The CPAs had the support of the American Institute of Accountants.

Meantime negotiations on a broad front between representatives of the bar and the CPAs were carried on, in an effort to reach an understanding which would eliminate such contests. While these negotiations had a somewhat checkered career, the upshot seemed to be: (1) disagreement on the need to amend Circular 230, (2) agreement that the Joint Statement of Principles is a good thing, (3) a Treasury interpretation of Circular 230 which supported the Joint Statement and reaffirmed the intention of the Treasury to control practice before it, (4) a continuing conciliatory attitude on the part of responsible leaders of both bar and CPAs (see ex-president of the American Bar Association William Jameson's comments at last month's AIA meeting, page 273 of this issue), and (5) a withdrawal from the *Agran* case of the AIA (but not of the California Society of CPAs).

By an interesting, and probably unfortunate, coincidence, the final opinion was handed down the day before the fall meeting of Council of the AIA. This prevented, of course, any real study of its import or deliberate discussion by that group, which is, after all, perhaps the most keenly interested in this whole question. (See also 4 JTAX 216 et seq., 5 JTAX 42.)

The present decision raises some very nice legal questions. What is the significance of the court's ignoring of the Treasury's recent interpretation of Circular 230? What are the constitutional implications? We have asked Reuben Clark, Jr., a Washington, D. C. attorney who has studied this whole question extensively, to give us his first impression of the decision. It appears below.

Meantime, the big question is: Will the organized accounting profession, either in California or nationally, back an appeal to the United States Supreme Court in an effort to further clarify the right to practice before the Treasury, and resolve the states-rights issue? ☆

New Agran decision raises constitutional questions; confuses rules of tax practice

by REUBEN CLARK, JR.

THE ARDUOUS JOURNEY through the Los Angeles courts of Mr. Reuben Agran, a certified public accountant and an enrolled Treasury practitioner, to collect a fee from a client for services rendered in settling the latter's tax liability seems far from over. With emphasis, the Appellate Department of the Superior Court, County of Los Angeles, State of California, has now affirmed its previous decision that Mr. Agran, in performing services before the Treasury Department that Circular 230 specifically authorized, was engaged in the "unauthorized practice of law" in California. The result arrived at is again the same: Mr. Agran cannot collect his fee in the courts of California for that part of his work which is held to be the practice of law. However, this decision is more significant than the first in that, whereas formerly the court carefully skirted the question of whether or not Treasury Regulations are pre-eminent over state authority, it now has met this issue head-on in a holding that throws down the gauntlet of states' rights to Federal authority. The court has said, in effect, that the Federal Government is constitutionally incapable of authorizing non-lawyers to engage in activities before the Treasury Department which may conceptually constitute the "practice of law" as defined by state courts.

Court usurps power to itself

The short opinion of the court, written by Judge Patrosso (who, incidentally, handed down the opinion in the original *Agran* decision), states that "To accept the plaintiff's argument [that a state may not regulate the practice of law within its borders by prohibiting laymen from practicing law at least insofar as relates to matters and questions arising under the Internal Revenue Code] would simply mean that the individual states are in effect deprived of their traditional and long-recognized right to regulate the practice of law within their borders at least insofar as such practice involves matters of so-

called 'tax law.' If this is to be the rule, we feel it should be announced by some higher authority." Defining in such terms the consequences of "the rule sought by plaintiff," the California court has, in the actual result reached, simply usurped power to itself.

States cannot restrict U. S. rights

The right of the individual states "to regulate the practice of law within their borders" does not, under our constitutional scheme of things, permit a state to enforce against Federal agencies regulations which in any degree impedes or clogs the functioning of the Federal Government. In particular, the courts, both state and Federal, have consistently declined to apply state law so as to restrict lay practice before Federal agencies, since the right of Federal agencies to determine the qualifications of those who appear before them seems exclusive. Whatever may be the authority of states to regulate the practice of law relating to practice before their own courts and administrative agencies, or whatever the authority of the judicial department of these states constitutionally to keep this authority in themselves instead of in state legislators, the fact seems well established that states cannot, under the Supremacy Clause of the Constitution, constitutionally prohibit lay practice before a Federal agency, if that agency, pursuant to Congressional authorization, permits such practice.[1]

In the delicate and eminently practical balance that exists between Federal and state authority, wide scope indeed exists—as the Federal authority has long recognized—for control, supervision and discipline of Federal practice and practitioners by the local courts.[2] But for state courts to bar non-lawyers from lawfully engaging in practice before Federal agencies by applying a semantic definition to such activity that encompasses practically its entire scope is to exceed constitutional bounds. Carried to its logical conclusion, the court's rationale here would, in addition to preventing non-lawyers from practicing before the Treasury Department, also prevent the Department from employing non-lawyers as members of its Appellate Staff to resolve "legal" matters—obviously an impossible extension of state power into the Federal area.

Serious impact on Treasury practice

If, however, this decision is a correct statement of Federal-state relationships, its impact on laymen practicing before the Treasury Department is extremely serious. It means that in those states which apply the California test of what constitutes "unauthorized practice of law" no accountant can continue to practice before the Treasury Department as heretofore without incurring the risk of being enjoined from such

COMPLETE TEXT OF FINAL AGRAN DECISION

THE APPELLATE DEPARTMENT of the Superior Court, Los Angeles County, California, on September 20, 1956, made public its decision in the appeal of *Agran v. Shapiro*. Judge Patrosso, with the concurrence of Judge Kauffman (Judge Bishop "concurred in the judgment") said:

"A reading of the record satisfies us that the trial court proceeded in accordance with the views expressed in our previous opinion (*Agran v. Shapiro* (1954), 127 Cal. App. 2d Supp. 807) which constitutes the law of the case, and we see no reason to depart from what is said therein. The findings are supported by the evidence.

"Neither are we impressed with the plaintiff's argument that the trial court erred in not making a finding to the effect that the Treasury Department treats alike enrolled agents and enrolled attorneys and that such a finding, if made, would have required the conclusion that this constitutes a practical construction by the Department of the Regulation in question that an enrolled agent in connection with matters arising under the Internal Revenue Code is authorized to do and perform acts which otherwise constitute the practice of law.

"Reduced to its simplest form, plaintiff's argument in effect is this: by virtue of the Treasury Regulation (C.F.R. 10.2) an enrolled agent though a non-lawyer is at liberty to perform any and all services and give advice upon legal questions which constitute the practice of law within the meaning of that term as generally understood so long as the work is performed or the advice is given in connection with a matter involving or arising under the federal Internal Revenue Code and pending before the Treasury Department. This is pointed up by plaintiff's suggestion that the decision in the *Bercu* case (78 N.Y.S.2d 209) would have been different if the respondent there had been enrolled (which he was not) as an agent by the Treasury Department, but if that court was correct, as we believe it was, in concluding that the services rendered by Mr. Bercu constituted the practice of law, the necessary effect of plaintiff's argument is that a state may not regulate the practice of law within its borders by prohibiting laymen from practicing law at least insofar as relates to matters and questions arising under the Internal Revenue Code so that what constitutes the practice of law no longer depends upon what is done but by whom. If this be true, the same act which would constitute the practice of law under the law of this State if performed here and which if performed by a non-lawyer not enrolled as an agent by the Treasury Department would subject him to criminal prosecution, would not constitute the practice of law if performed by a non-lawyer so enrolled. To accept the plaintiff's argument would simply mean that the individual States are in effect deprived of their traditional and long recognized right to regulate the practice of law within their borders at least insofar as such practice involves matters of so-called "tax law." If this is to be the rule we feel it should be announced by some higher authority.

"Nothing said herein or in our previous opinion implies a holding, as plaintiff seems to think, that the Treasury Department may not prescribe the qualifications of those whom it will recognize as agents or attorneys of others having business with the Department but rather that by such recognition it may not confer upon persons who are not members of the bar authority to perform services within a State which, under its laws, constitute the practice of law in violation of that State's laws.

"The judgment is affirmed." ☆

practice, or of being legally unable to collect fees, or, possibly, of criminal prosecution. It means that the right of laymen to practice before the Treasury Department may hereafter depend on geography, since Mr. Agran's activities would not, presumably, have constituted "unlawful practice" in New York.[3] It means that such professional groups as accountants will in many states be forced to seek enabling acts from state legislatures in order to continue Treasury practice lawfully. It further means that, in some instances, they may even have to obtain state constitutional amendments in order to legalize the work before the Treasury Department that they have been doing for 40 years. Needless to say, the uniform administration of the tax laws has been dealt a potentially crippling blow.

Circular 230

It can be doubted that the constitutional viewpoint enunciated by Judge Patrosso will stand up. But even assuming its eventual judicial demise, a further threat to the practice of laymen before the Treasury lurks behind the facade of this opinion. It may significantly be noted that Judge Bishop concurred only "in the judgement." This fact probably means that he did not subscribe to Judge Patrosso's comprehensive denial of Federal authority to regulate lay practice before the Treasury Department if such authority conflicts with state concepts of the "unauthorized practice of law." But nevertheless he arrived at the same result. It would appear that he drew from Circular 230—and its recent interpretation by the Treasury Department which was not cited by the Court[4]—the conclusion that the Treasury Department did not *intend* to extend the scope of its practice for non-lawyers to a degree that would conflict with the California concept of the "unauthorized practice of law." In other words, he seems to have found the recent Treasury interpretation ot be sufficiently ambiguous so as to warrant a conclusion that the Department did not desire to protect non-lawyer accountants practicing before the Department from state interference. Otherwise it is difficult to see how Judge Kauffman could have subscribed to Judge Patrosso's result without endorsing his reasoning. If this observation is valid, the existing ambiguity of the Treasury Regulations—quite apart from constitutional requirements—can justify the result here reached.

Before this most recent decision, the real question raised by the *Agran* litigation was, in effect, the proper interpretation of Circular 230. Did these Regulations indicate Treasury intent to permit non-lawyer enrollees to perform certain functions before the Department without regard to state concepts of what constitutes "the authorized practice of law"? The first *Agran* case found that the Treasury Regulations did not so evidence this intent. Subsequently, the Treasury issued its controversial interpretation, which may or may not have made its intent clear.[5] Now the California court has proceeded to dispose of the question on constitutional grounds alone. Regardless of Treasury's intent, says this court, it lacks the constitutional authority to allow non-lawyers to "practice law" before the Treasury Department, if state courts object. Thus, even if this conclusion is judicially reversed, the old question will remain: What is the scope of practice that the Treasury Department has really intended to bestow on its non-lawyer enrollees?

The constitutional issue must, of course, now be resolved "by higher authority." But, in the last analysis, the lawyer-accountant controversy over Treasury practice is not going to be settled until the Treasury Department finally grasps the nettle of responsibility and clearly sets forth in its own Regulations the role its lay enrollees are to play. This it must do in a way that realistically recognizes the necessity for, and the limitations of, practice by laymen before the Department. Also, the quite legitimate claims of local authorities for a voice in this regulation must be taken into account. To help resolve the controversy in these terms is fully as great a challenge to lawyer enrollees as it is to their lay fellows. ☆

[1] For a discussion of authority in this point, see Clark, *Accountants in Treasury Practice: The Department Regulations Should Adopt the Bercu Rule*, 24 G. Wash. L. Rev. 377, 385, 386 (1956). See also R. JTAX. 216, 217 (April, 1956) and 5 JTAX. 185 (September, 1956).
[2] See Clark, note 1 *supra* at 396 *et. seq.* See also 4 JTAX. 306, 307 (May, 1956).
[3] See Clark, note 1 *supra* at 383 *et seq.*
[4] 21 Fed. Reg.. 833 (Feb. 7, 1956).
[5] See 4 JTAX. 216 *et seq.* (April, 1956); 4 JTAX. 306 (May, 1956); 5 JTAX. 42 (July, 1956).

Controversy with CPAs over tax practice not wanted by most lawyers, says Bar official

"ALTHOUGH I have been active in bar association work for many years, up to three years ago I was not even aware of any controversy between lawyers and CPAs," said William J. Jameson, former president of the American Bar Association, speaking at the annual meeting of the American Institute of Accountants late last month in Seattle.

"In my judgment," he said, "the vast majority of the lawyers of the country today are, at most, only vaguely aware of the existence of any problem. In most communities the lawyers and certified public accountants get along very well together, and there is a feeling of mutual respect and confidence. That does not mean that there is no problem, as I have learned during the past two years as chairman of the American Bar Association Committee on Professional Relations."

When I was asked to serve on this committee, he continued, I accepted wiht some misgivings because of my unfamiliarity with the problem, but entered upon the assignment with a high degree of optimism. It seemed to me that reasonable men should be able to agree upon what constituted the practice of law and the practice of accounting. I soon found the problem was not that simple.

I was soon convinced that the National Conference of Lawyers and Certified Public Accountants had made the right approach in 1951 in formulating a Statement of Principles for the guidance of the members of each profession in the field of Federal income taxation, without attempting a precise definition of the practice of law or the practice of accounting. The more I study that Statement, which as you know was officially adopted by your Institute and our Association, the more I am impressed with the wisdom, fairness and statesmanship of the members of our two professions who comprised that conference. This statement today affords a sound basis for mutual voluntary cooperation between the legal and accounting professions in the public interest.

At our initial meeting of the Conference, we started out by trying to determine just what might be involved. There were many questions with respect to specific problems, and this was the interesting fact: all of us at that meeting could agree substantially upon each one

of those specific problems. Let me give you just two examples, because I think they illustrate very well some of our problems.

One of your committee raised this question: "Is it your opinion that whenever accountants examine and apply regulations or statutes or decisions, they are practicing law?" Thomas Tarleau, a former chairman of our Tax Section, replied for our committee. He said, "Of course not." He used this illustration: "Suppose, for example, an accountant is consulted with respect to an organization which is clearly a Massachusetts trust for the handling of real property, and the question arises as to the type of return which should be filed. You will not find the answer in the statutes. You will not find it in the regulations. But you will find a decision of the United States Supreme Court directly in point. You advise your client on the basis of that decision. You are not then practicing law. But, on the other hand, suppose there is a New Hampshire trust for the handling of real property, or some other type of organization which does not come within the decision and there is a substantial legal question, in other words,—a substantial legal uncertainty. Then that is the time when you should call in a lawyer."

That conclusion was not questioned by the other members of either committee.

I recall another question with respect to a corporate spinoff. We all agreed that a lawyer should be called in by the accountant; but I recall that one member of your committee, who came from a relatively small community said, "I agree with the rest of you. The only trouble is that in my town, whenever we have a question like that and I go to one of the lawyers, he usually says, "You know more about that than I do. You go ahead and prepare it." That points a need for education among members of my own profession—a situation which fortunately is improving through tax institutes and other activities by the organized Bar and various law schools. Certainly as lawyers we have a definite obligation to be prepared to advise our clients on legal problems arising in the tax field.

Problem different in small communities

This illustration suggests also that the problem is often quite different in small communities. It is true that in many communities there are no lawyers who are interested in or engaged in tax practice. Conversely, in other communities there are no certified public accountants, and all of the tax work is performed by lawyers. Of necessity in both of these situations, there is perhaps more encroachment upon the fields of the other profession than is desireable or should be permitted in communities which are properly and adequately served by both professions.

No agreement on Circular 230

While your committee and ours could agree in substance upon specific problems, upon the desireability of education of both professions and upon a reaffirmation of the Statement of Principles, we could not reach an agreement with respect to the Institute's proposal to amend Treasury Circular 230. In view of subsequent developments, I see no useful purpose in reviewing our negotiations and discussions in any detail.

Very briefly, it was the position of the Institute that the right of an enrolled agent to practice under Section 10-2(b) of Treasury Circular 230 had been put in question by the *Agran* decision in California, and that clarification by the Treasury Department was necessary to prevent litigation in state courts, resulting in differing and inconclusive interpretations of what certified public accountants were authorized to do.

It was the position of the American Bar Association that any amendment proposed would have the effect of nullifying the proviso of Section 10-2(f), i.e., that nothing in the Regulations "shall be construed as authorizing persons not members of the Bar to practice law," and would be tantamount to authorizing an enrolled agent to practice law, thus inhibiting the regulation of the practice of law by the several states, and that the problem could be solved by conference and negotiation without amending Circular 230.

Not all of us think alike

I think one other matter should be made clear at this point: There are differing viewpoints among accountants and likewise among lawyers with respect to this problem. Perhaps the extreme viewpoint on the part of some accountants is this: Regardless of the legal question, that is, the extent or nature of the legal question involved, there is no occasion for an accountant to call in a lawyer in practice before the Treasury Department under Section 10-2(b). The extreme viewpoint on the part of some lawyers is that the application of any statute, Regulation or decision, or the use of any legal technique whatever, constitutes the practice of law and should not be engaged in by any accountant.

Neither of these viewpoints is realistic or tenable, and I think this is recognized by most accountants and most lawyers. But the problem of finding a satisfactory compromise between the two viewpoints and finding satisfactory language to express an agreement, proved exceedingly difficult.

Interpretation of Circular 230

As you know, when our two organizations were unable to reach an agreement, the Department of the Treasury issued an official interpretation of its Circular 230. While the interpretation might not be wholly satisfactory to many members of the Bar, and not wholly satisfactory to many members of the Institute, in my opinion the Treasury Department arrived at a realistic approach to the problem. The Department did not ask for specific approval by either the Institute or Association. Both groups were called by the Under Secretary of the Treasury and given an opportunity to suggest language which might be incorporated in the statement. Both sides made some suggestions. Some were adopted; some were not. It is our hope, and I am sure it is your hope, that our two professions will now be able to proceed with the conference method in attempting to negotiate any differences existing between us.

Differences are magnified

In my judgment these differences have been magnified. They have resulted in part from lack of understanding of the viewpoints of our respective professions, and in part from unfounded fears of the purposes and designs of our respective organizations. I have referred to the fact that insofar as lawyers are concerned, we have a small group who take an extreme view that cannot possibly be justified and that the vast majority of the profession are not even concerned with the problem. There is a third group: They are sincerely interested, fully informed, and are genuinely concerned with the obligations and responsibilities of the legal profession and what is often termed the unauthorized and unqualified practice of law. You have their counterpart in the Institute. They are able and sincere exponents of

the obligations and responsibilities of your profession. Both sides point to the "bad boys" in the other group. That does not mean, however, that their viewpoints are irreconcilable.

Last February, Maurice Stans, your distinguished past president, addressed a meeting of the Conference of Bar Presidents in Chicago. He clarified many misunderstandings. He also pointed out that "the differences that have existed between us, if you really analyze them, are hypothetical, are theoretical differences between our two organizations, and not differences really between individual members of the two professions who work together every day."

Dean Griswold of Harvard Law School puts it this way: "It is a great mistake, I think, to blow this question up to too great importance. In my experience, lawyers and accountants have got along very well together, each performing a specialized service of complexity and importance to his clients. In the tax work being done, I know of very little friction between lawyers and accountants. If people would cease being excited, my guess is that the situation would move along with considerable satisfaction to the client; and with little difficulty for the two professions, for a long time . . . This is a great country, and I get the impression that accountants, with very few exceptions, are doing what they want to do without harassment. This is an area where it is extremely difficult to lay down explicit rules. Wouldn't we be better off if we could just let well enough alone?"

Just a few days ago I read a very interesting review of our controversy entitled "Practice of Taxtion; Accountants vs. Attorneys," by Orville J. Weaver, a second-year student at Cleveland-Marshall Law School, who is a certified public accountant. After an interesting and rather comprehensive review of the differences between the two professions, he concludes: "May we add that the close cooperation of the two professions and a sincere attempt by each to understand the problem of the other, and the recognition by each of its own limitations, would lead to a successful end to the controversy."

Finally it must be clear that the solution of any controversy between our two professions must not be considered from the standpoint of prevention of competion, but must be predicated upon service to the public. This was clearly recognized in the Statement of Principles in its stated purpose to indicate the importance of voluntary cooperation between the two professions "whose members should use their knowledge and skills to the best advantage of the public." In other words, the public interest is paramount. The public, in this instance the taxpayer, is interested only in getting the maximum service and protection; and these objectives quite properly were uppermost in the minds of those who drafted and agreed upon the Statement of Principles.

The adoption of the Statement of Principles, we found, did not automatically resolve all problems which might arise between the two professions with respect to tax practice; but I cannot help feeling that a faithful adherence to these principles by both professions will go a long way towards solving many problems which might otherwise be the subject of serious controversy. Throughout the statement it is recognized "that lawyers should encourage their clients to seek the advice of certified public accountants whenever accounting problems arise, and certified public accountants should encourage clients to seek the advice of lawyers whenever legal questions are presented." It is recognized with respect to all proceedings "that the taxpayer, in many cases, is best served by the combined skills of both lawyers and certified public accountants, and the taxpayers, in such cases, should be advised accordingly."

Both lawyers and accountants assume an unwarranted and unnecessary responsibility in invading the field of the other, sometimes with disastrous results to themselves, and what is more serious, to their clients as well. Certainly it is the wiser course to avoid this risk and whenever any doubt arises, advise the client to consult a member of the other profession.

It is true, of course, that differences have arisen in the application of the Statement of Principles in determining when a member of the other profession should be consulted. Differences will continue to arise in the future. But let us hope that when they do arise, they may be settled around the conference table at either the local, state or national levels. I can assure you that the committee for which I speak will do what we can to promote this result and will consider any controversies or problems referred to us in a spirit of mutual goodwill in an effort to arrive at a satisfactory solution. ☆

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TAX STRATEGY NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B. CPA

Tax Court backlog now some 9,000 cases; 1954 Code cases not heavy yet

TAX MEN planning to litigate in the Tax Court can get some idea of how long they will have to wait by this exchange of remarks between the Chief Judge of the Tax Court, Judge Murdock, and Rep. Gary at the recent hearing on the Tax Court budget.

Mr. Gary. Last year we were fearful that the new tax law would add very materially to the workload of the court because of the additional questions that would arise in the interpretation of the new law. Have you felt the effect of that law up to the present time?

Judge Murdock. No. Due to the statute of limitations we do not begin to get these cases until about two years after the law becomes effective. They are still struggling with it in the Internal Revenue Service until the statutory period for the Commissioner to assess an additional tax is about to expire, and before that time we hope, as taxpayers, that they will send out the statutory notice and it is at this point that they get into our court. For the present we have not had any increase.

Mr. Gary. Have you had any substantial increase in your workload this year?

Judge Murdock. No; not due to any new law. We have not had any. It has held the same.

Case backlog

Mr. Gary. Do you have any backlog in your court at present?

Judge Murdock. Yes; we have, and it is a matter of great concern to us. As of the end of the calendar year our total number of pending cases was 9,757. That was on December 31, 1955.

You might be interested to know that as of a year ago, December 31, 1954, we had 9,815 cases pending so that we are under that number by about 58 cases.

There is another thing that is good from that same standpoint. You know, we took on the renegotiation of contracts jurisdiction at the request of Congress in about 1942, and that represented a very substantial piece of work. It may now soon expire. We have only 89 cases out of 929 which were docketed.

Another burdensome part of our job are the relief cases which arose during the war years from the excess-profits taxes. We refer to them as Section 722 cases. That is the provision of the statute that gives relief from excess-profits taxes in exceptional cases, and there was no fixed standard set up by it. Its tests are all relative and that caused considerable difficulty. That problem is about to end too. As of December 31 we still had 659 of those cases pending. However, the good news is that in the Internal Revenue Service, where more can come from, they have only four that are under field investigation, three that are under consideration by the Excess Profits Tax Council, and 40 which are awaiting statutory notice of one type or another, so that potentially there are only 47 more cases that can come to us out of that category of cases. They take a long time to try, and they are very difficult to dispose of. They take much more than the ordinary tax case, so that I am personally glad to see them going out of the picture. Once we get those out of the picture then I think our backlog of normal-tax cases, which at present is about 9,000, will be reduced. I do not think that we are suffering too much about it, but at least theoretically we ought to be able to get rid of cases sooner if we do not have so many cases pending. In other words, if we could get down to about 6,000 that ought to be, I should think, about right.

I was head of this organization previously, and one time we got down to 4,419 cases. That is the lowest we have ever gone. Then additional work came in and we bounced up to 15,000 at one time, and now we have come down below 10,000 again.

This almost all depends upon how wide the faucet is opened in the Internal Revenue Service. They have these millions of cases. If they relaxed the least bit we would be flooded immediately. If they can keep them tight so that fewer people are dissatisfied and want to come in and litigate, then we are able to keep abreast. So that, depending upon how well the Commissioner of Internal Revenue handles his men under him, the thousands of people under him, our backlog goes up or down.

I think it is greatly to his credit that we are as low as we are, considering that we are now just coming up to the tail end of the war years, the years now being litigated.

We are in pretty good shape, but with no chance of ever running out of work. One time while I was on the court we had 22,000 cases pending.

Increase of trial time

Mr. Gary. With the additional services of another trial judge, why cannot the trial program be increased above 175 weeks?

Judge Murdock. I think it is doubtful if we can get up to 175 weeks, Mr. Chairman. There is no use of sending a judge out to try new cases if he has more on hand than he can get rid of in a reasonable length of time. When I inherited this job on July 1, 1955, some of the judges were already stocked with cases. It is almost unavoidable. I will give you an example. Suppose we take the calendar in Chicago.

We receive from the Commissioner of Internal Revenue a rough estimate, and when I say rough I mean rough as to the amount of estimated trial time required in those cases. In most cases they do not present evidence themselves. They defend them, and it is up to the other side to present evidence. They do not know too much about what the other side will take up in the way of trial time. We put in the Bureau's estimate of 240 hours of trial time on the Chicago calendar. That, we expect, is going to take 2 weeks' trial time. There are only 30 hours in a trial week.

Then notices are sent out to the parties as far ahead of time as we can, which is 90 days, preferably, if we can arrange for a courtroom at that time. Immediately those notices go out the In-

ternal Revenue Service representatives in that district begin to call up these taxpayers on the phone and to write them letters to see if they can get them to come in and either stipulate or settle these cases.

The result is that when we get out there they have either settled a number of cases or asked for a continuance to negotiate a settlement, and they get down to perhaps 45 or 40 hours of trial time, or maybe less, but we have to get a good break on settlements to avoid running up a backlog of cases for the particular judge that would really be a burden on him. He might get enough cases for four or five calendars like that, and be really overstocked.

That was true of some of the judges at the time I came in. I had to cut down on the trial calendar last fall, because the judges were not ready to hear new cases.

It is very wrong, in my opinion, to have cases in the hands of the judges any longer than they have to be. For instance, you really do not want your case in the hands of the judge for as much as a year.

Effect of informal conference ban

Mr. Gary. In your opinion is the big increase in the workload of the court related to the abandonment of the informal conference procedure by the Internal Revenue Service?

Judge Murdock. That I would not be able to answer. From my observation I think the Service does a good settlement job on these cases once they get before the Tax Court, and they must be doing a good job in keeping them out too because they have 60 million or 70 million returns filed every year and we get only four or five thousand petitions filed. That is a pretty good piece of work, I should think.

Certainly, Coleman Andrews when he was there was very much interested in preventing any greater number of petitions coming in than necessary and he believed in settling whatever cases they could after they got there, so that our actual trial and decision of cases would be reduced to a minimum. I have not met Mr. Harrington yet, but I am quite confident that his ambitions will be along the same lines. I intend to discuss it with him, when he gets his other affairs straightened out a little better, as to how important that is to us because we do very little of the total amount. The Commissioner settles cases by the million. We do it by the hundreds, and so relatively it is small.

Mr. Gary. But you get the most difficult cases, the ones they cannot settle.

Judge Murdock. That is right. Some of them are extremely difficult. Others are difficult only because the taxpayer does not realize the difficulty he is in or what the law is. We have a good many of those cases.

Sometimes the Commissioner refuses to settle some particular type of cases and we will get a lot of those. He was afraid of those fraud cases when Congress was kicking those around so much, and it showed up in our work because they were hesitant about settling them, apparently. That was my guess, and we certainly got a lot more of them. When we got to the trial of them we discovered quite a lot of them could be settled profitably. ☆

AIA denies that CPAs are dissatisfied with issuance of new Regulations

REPORTS that the American Institute of Accountants was dissatisfied with progress being made by the Treasury in issuance of new Regulations under the 1954 Code were flatly and vigorously denied by J. S. Seidman, chairman of the Institute's committee on federal taxation. A story appeared in the *Wall Street Journal* of August 22 saying "The Treasury drags its feet issuing new regulations, CPAs complain." The story then went on to say that accountants are dissapointed that the Regulations so far issued have raised as many questions as they have answered; that only 28 out of a total of 105 Regulations had been issued at that time.

Mr. Seidman, speaking at the AIA annual meeting in Seattle late last month, said he wanted to correct the blunt misstatement in the newspapers. At no time, said he, has the AIA ever indicated its dissatisfaction with the timing or scheduling of the Regulations. On the contrary, he said, members of the Institute have repeatedly suggested to him that, considering the difficulty of preparing and issuing the new Regulations, that good progress was being made. Mr. Seidman compared the difficulty in formulating Regulations with the difficult and time-consuming task of issuing Accounting Research Bulletins and Statements on Auditing Procedure.

An unfortunate coincidence may have had something to do with the newspaper story which caused this confusion. The AIA held a press conference on Tuesday, August 21, to present to the press its views on the need for further study of the whole tax system [see 5 JTAX 240, which last month summarized the AIA's recommendations]. The *Wall Street Journal,* in its regular Wednesday tax column, reported the policy story from AIA. But apparently the *WSJ* had already that week interviewed some CPAs, apparently not official spokesmen for the AIA, from which CPAs must have come the protests about the slowness of the Regs. The *WSJ,* in juxtaposing the two stories, may have permitted some readers to infer that the AIA was speaking officially on both points. Actually, the two were quite separate in origin, though reported together.

Bar applauds IRS

Shortly after the *WSJ* story, the American Bar Association's Section of Taxation, in annual meeting, passed a resolution commending IRS for its issuance of Regulations, and for the considerations given recommendations of Bar groups in writing the new Regulations. ☆

Harrington says "quota system" is dead

THE USE OF production quotas for intelligent, difficult work (such as that done by Revenue Agents) is "fantastic", says Commissioner of Internal Revenue Russell Harrington. In discussing his efforts to eliminate the quota system (and any idea among tax men that such a system existed) he said "I hope I have laid this 'quota system' body to rest for ever."

In spite of the unsuitability of a quota system for such work, says the Commissioner, it does seem to have happened in some places. "I told them," said Mr. Harrington," that we were not going to measure a Revenue Agent's performance by his output *solely.*" But this was misunderstood, he continued, by some to mean that there were no work standards whatever. In a large organization there must be some way to

measure or control work (but this is much different from a quota system). Even though we may take into consideration the production of an Agent in evaluating his performance, there is no penalty for low output in the present system. ☆

IRS district audit chiefs to head up conference staffs

SPECIFIC RESPONSIBILITY for the new informal conference procedure [see 5 JTAX 224] is being assigned to the Chief of the Adult Division in each IRS District Office, Commissioner Harrington said at the American Institute of Accountants annual meeting last month. We are, he said, "establishing new procedures for the Informal Conference function under which we attempt to settle, at the district level, disputed cases between the taxpayer and the Internal Revenue Service.

"We are undertaking to establish more effective direction and control of this function; to provide greater flexibility to meet the needs of particular taxpayers.

"At the same time we are seeking to preserve as much as possible of the informal, low cost aspect of the existing procedures. We believe the new system will enable us to render better service to you and your clients.

"We are assigning specific responsibility for the direction and execution of the informal conference function to the Chief of the Audit Division in each District Office. Where the Chief is not in a position personally to discharge these responsibilities, he will delegate them to a conference coordinator under his immediate direction.

"It is likely most of the larger offices will have a full-time conference coordinator, and in the very large offices he will have assistants.

"The coordinator will assign cases; he will furnish technical advice to other conferees; he will conduct conferences himself in more difficult cases; he will seek to achieve uniformity in cases involving the same issues; he will screen all formal protests to see if further action by the Audit Division is required prior to referral to the Appellate Division." ☆

New procedural decisions this month

Deduction of wrong amount good election to expense intangible drilling. Taxpayer followed the practice of capitalizing drilling costs and deducting depreciation on tangible and depletion on intangible. It had its first nonproductive well in 1946, and three more in 1951 and 1952, the years in issue. In 1946, it expensed the costs and deducted tangible but showed the intangible as a nondeductible surplus charge. In 1951 and 1952, it claimed a deduction for both tangible and intangible. The deduction of the tangible is conceded to be proper. The intangible it claimed on the ground that the 1946 return as a "clear indication" of its intention to elect to deduct intangible costs of unproductive wells. The court agrees. No form of election is required by the Regulations. It claimed what it considered a proper deduction in 1946. It did not capitalize any part of it. *Ravencliffs Development Co.*, DC W. Va., 8/23/56.

Nunan conviction affirmed. In a long review of the evidence and consideration of the objections to trial procedure, the court affirms the conviction of this former Commissioner of Internal Revenue. The court places great emphasis on taxpayer's lack of records, his extensive cash transactions and the fact that he prepared his own returns, listing round amounts with little or no identification. *Nunan*, CA-2, 9/6/56.

Payment before assessment does not start limitations. Decedent signed a waiver of restrictions against assessment of his 1941 gift tax liability and gave the Collector's office a check on December 24, 1944. The deficiency was listed on an assessment list certified by the Commissioner on January 29, 1945. Decedent filed a refund claim on December 24, 1947. The court holds that the payment of December 24, 1944 was merely an advance. The deficiency was not brought into existence until January 29, 1945, and the three-year statute of limitations began to run on that date. The refund claim could therefore be allowed (it was agreed that refund was proper if the claim was timely), but as a partial offset, the amount of the claim is includible in decedent's gross estate and is subject to estate tax. *Moritz Estate (Holland, Ex'r)* DC NY, 7/9/56.

Filing Tax Court petition prevents district court suit. The trustee filed a petition in the Tax Court to review an estate tax deficiency; he cannot bring suit in the district court for refund of this tax. Although the question was not *litigated* in the Tax Court, the mere filing of a petition there is a complete bar. *Diaz-Albertine, City Bank Farmers Trustee*, DC NY, 7/17/56.

Commissioner's recovery under 3801 opens another year for taxpayer. Taxpayer had reported capital gain on liquidating distributions in 1946 and 1947. In another case, she sued for refund on the ground that she had erroneously reduced the basis by distributions in 1932-1942. She argued that those distributions were really dividends. The court agreed. It allowed the refund for 1947 but held that the 1946 claim had not been timely filed. It also allowed the Government's counterclaim under Section 3801 for the tax on the dividends for 1932-1942. That decision was made in 1952.

Taxpayer then claimed that 1946 should be considered opened under 3801 by reason of the determination in 1952 that the 1932-1942 payments were dividends and the Government's collection of the otherwise-barred tax on them. The district court agreed and this court affirms. All the conditions for opening a barred year are present. The Government's position for 1946, that the distributions were capital, is inconsistent with its demand for tax on them granted as an offset against 1947 tax. *Rosenberger*, CA-8, 8/15/56.

Three-year refund claim rule applies whether or not related to transaction on return. Taxpayer filed a claim for refund within three years after he filed the return. The claim was based on error in reporting community income as separate and in application of taxes paid by wife. The Government argued that the three-year period applies only if the claim is based upon an error in an item reflected on the return. The court said there is no basis for such an argument. The taxpayer can always use either the three-years-after-filing or two-years-after rule, whichever is more favorable. *Musser*, DC Calif. 8/8/56.

Taxpayer bound by informal deferment; IRS has extra time for assessment. Under EPT, a taxpayer was permitted to defer payment of part of the tax for

which it claimed 722 relief on Form 991. The Government then had until one year after determination of the 722 claim to assess the deferred tax. Taxpayer here reduced its 1943 EPT tax, noting on form, "per 991 for 1942." It filed a 991 for 1943 in 1946. The EPT claim was denied and tax assessed for all years. Taxpayer now claims that the regular three-year rule applies to 1943 because the deferment was improper. The Court disagrees; the IRS waived the requirement that 991 be filed when it permitted the deferment. *Sunland Industries, Inc.*, DC, Calif., 4/19/56.

Taxpayer bound by 870; too late for Commissioner to recoup on related cases. Taxpayer signed an 870TS (waiver of restrictions on assessment). Taxpayer argued that it was not bound until the Commissioner also signed. The court agrees. However, the Commissioner accepted (though it did not notify taxpayer) and assessed tax prior to closing of time. The court rejects taxpayer's further argument that it was not bound because an 870 was not a binding closing. Though some courts have so held, the taxpayer here must be bound because this is one of the six related cases, and it would be unfair to allow taxpayer to open his case while the Commissioner is unable to make corresponding adjustments in the related five cases. *Goldberg Estate (Girard, Ex'r)* DC NC 7/25/56.

Differences under two Codes on limitation period for carrybacks explained. The IRS here sets forth the differences in the 1939 and 1954 Codes regarding the period of limitations applicable to deficiencies attributable to erroneous carryback allowances. *Rev. Proc.* 56-27.

No interest on refund if taxpayer causes delay. Interest will not be allowed for the period the Government was delayed in effecting delivery of a refund check because of taxpayer's failure to comply with the conditions required for a refund of over-payment. *Rev. Rul.* 56-445.

Interest runs till Commissioner accepts offer. Taxpayer agreed, in June 1951, to additional tax. The Commissioner accepted in May 1952. The agreement became effective only on acceptance. Interest runs till then. *Algodon Mfg. Co.*, DC NY, 7/24/56.

After election, amended return ineffective without Commissioner's consent. Taxpayer paid a federal tax assessment in 1949 and deducted interest paid. Upon suit for refund, he recovered the interest in 1951. He did not include the interest as income in 1951. Instead he filed an amended return for 1949, omitting the interest deduction. At issue here is the 1951 return in which the Commissioner included the refund as income. The court holds that the Commissioner was correct; the deduction in 1949 was proper, and there is no statutory provision for amended returns. *Klinghamer*, DC Kan., 7/18/56.

Jury finds failure to report $43,000 income willful. The jury finds defendant guilty of willful failure to file an income tax return. The indictment charged him with an income of $43,000. *Haskell*, DC Colo. 5/3/56.

Interest on overpayments under '39 Code allowed only if claim filed. Where a net operating loss is sustained in a taxable year ending in 1954 and is carried back to taxable years ending under the 1939 Code, interest on overpayments of tax attributable to the carry-back is allowed only for the taxable year or years for which a claim for refund is filed. The 1939 Code specifically provided that interest on refunds arising out of loss carrybacks was payable for only the period following a claim for refund. Under the 1954 Code, interest is payable from the year of loss. *Rev. Rul.* 56-413.

Deficiency barred by three-year statute. The Commissioner admitted that the notice of deficiency in this case was mailed more than three years after filing of the return, and he offered no evidence to suspend or interfere with the running of the statute. The action is barred. *Licovali*, TCM 1956-187.

Government can't reopen year after Tax Court approves stipulated compromise. The district court enjoins the district director from collecting an alleged deficiency. The Commissioner and the taxpayer had previously entered into a stipulation, agreeing to a compromised amount of tax after taxpayer petitioned the Tax Court. This was approved by the Tax Court and the tax was paid. *Lenny*, DC Ohio, 7/21/56.

Widow liable for husband's taxes, but assets received as dower are exempt. The estate of taxpayer's husband was administered by a receiver appointed by a state court. She was executrix. The receiver paid over the estate to her and other heirs and had no funds to pay prior year's income taxes of the husband. The court holds that amounts paid to taxpayer as dower are exempt from the Government's tax claims, but the sums paid her on account of loans are not. *Hicks*, DC Fla., 7/18/56.

Motion to set aside stipulation denied because made too late. On October 3, 1955, taxpayer filed a motion requesting leave to withdraw its stipulation dated September 27, 1951, and to revise the decision entered that year pursuant to such stipulation. The motion was predicated on the alleged mistake of the parties and the fraud perpetrated on taxpayer by its president and CPA, which facts were first disclosed to taxpayer on June 4, 1954. Noting that no reason is given for the 16-month delay in filing the motion, the court holds the motion was not timely and denies relief to petitioner. *Jefferson Loan Co.*, TC 5/25/56.

Collateral estoppel applied to deny EPT relief. In a prior Tax Court decision, taxpayer was denied excess profits tax relief under Section 722 for 1941 on the grounds of insufficiency of evidence. Alleging facts substantially identical to the allegations in the prior case, it now seeks similar excess profits tax relief for 1942 to 1945. The court holds the prior decisions bars the present action under the doctrine of collateral estoppel; the facts and issues of the previous case are the same as those here. *Stern & Stern Textiles, Inc.*, 26 TC No. 129.

MOST CPAs LIKE APRIL 15

THE NEW APRIL 15 filing date for personal federal income tax returns pleases most CPAs, even though it's murder for the Florida hotel owners. At least the elevator operator in our building *says* it's killing the post-tax-season rest cure for tax men in Florida. "By April 15, the weather's nice in New York then," he says. He must be meaning some other year.

Anyway, the CPAs, in responding to a survey made by the American Institute of Accountants voted 1151 to 306 against the restoration of the March 15 deadline. ☆

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

Johnson case solves some problems of the installment seller

by **ARNO HERZBERG**

Under the old rule that a dealer's income is not reduced by the amounts which finance companies withheld, much confusion and financial stringency existed. Although the Johnson case, which the Government won't appeal, solves one problem, the question of how to handle commissions allowed the dealer still remains. Not a little of the confusion in this field is due to the trade habit of calling all holdbacks, commissions and pools "reserves."

OUR PROSPERITY in the postwar era has been largely based on consumer financing. Although its mechanics are simple and easily understood, its tax implications are somewhat nebulous and much confusion exists in this field.

A finance company or bank buys from the dealer a "contract" he has with his customer. This customer signs a note for an amount which includes, as a rule, three items: (1) the balance of the purchase price that is to be financed; (2) insurance, if any, on the purchased item; and (3) finance charges, comprising interest and handling fees. After the dealer turns this note over to the finance company, he generally receives the unpaid balance of the contract.

At this point two kinds of "reserves" enter into the picture. Each has to be distinguished in order to avoid confusion and misunderstanding.

Two kinds of reserves

Many finance companies buy contracts only if the customer has a sufficient equity in the property purchased, e.g., if he has paid down a substantial fraction, generally more than one-third, of the sales price. If the purchaser does not meet this requirement, the finance company buys his paper only if the dealer agrees that the difference between the financed amount and one-third of the sales price will be retained by the finance company until the buyer has made a sufficient number or, in most cases, all the payments. In other words, the finance company remits to the dealer only two-thirds of the sales price, although the financed amount might be higher. If a car is sold for $2,700 and $2,100 is financed by the buyer, the finance company would not pay the dealer $2,100; it would retain $300 — the difference between $2,100 and $1,800, two-thirds of the sales price. The retained amount is credited to a special account for the dealer as a cushion against possible repossessions and losses. In the trade, it is called a holdback.

Then there is another kind of reserve. It is actually no reserve at all, although businessmen have become used to this term. It is a commission contingently credited to the dealer. Such a commission is a portion of the customer's finance charges allowed the dealer to induce him to sell contracts to the finance company. It is figured according to a formula sometimes quite complicated, involving time of financing, amount financed, insurance premium financed, interest and other items. The dealer has no right to withdraw these amounts credited to him. In the first place, the amount of the "reserve" of each individual deal is not fixed until the purchaser's contract obligation has been paid up. In the second place, there might be other obligations the dealer has toward the finance company; the "reserves" are retained to secure them.

Holdbacks and reserves are thus entirely different. They involve, as we will see, quite different tax problems, although courts and authors have persistently called a reserve what was actually a holdback, and have quoted decisions on holdbacks in order to prove the taxability of reserves. In view of the many different items which accountants call reserves, it is not surprising that nonaccountants are confused.

Typical of this confusion is the leading case which has been heavily relied upon in all subsequent Tax Court decisions, and from which evolved the guiding principle that was supposed to solve all problems of taxation of holdbacks and reserves.

In *Shoemaker-Nash*[1] the Tax Court refers to a holdback as reserve. The dealer there sold installment paper to the finance company which retained a portion of the sales price and paid it to the dealer only when the customer paid the notes in full. On his books, the dealer showed only the amounts actually received from the finance company. Amounts exceeding these payments, but retained by the finance company, were recorded in a memorandum. They were however shown on the balance sheet of the firm as an asset and were offset by a provision called "repossession losses."

The Shoemaker-Nash case

The indications are that the finance company did not have the right to charge uncollectible notes to the holdback account. The holdback in this case was nothing but a plan set up by the finance company to defer payment to the dealer of a portion of the purchase price of the notes. The Board of Tax Appeals said: "For, although the amount of the reserve credit is not immediately paid and does not immediately become payable, there is no showing that it will not become collectible when due or that its collection in the future is improbable." Therefore, the Board concluded, the dealer's income has to be computed on the entire amount of the selling price of the notes at the time they were sold.

The point made in *Shoemaker-Nash* that it was not shown that the holdback would "not become collectible when due

and that its collection in the future is improbable" was neglected in all subsequent Tax Court decisions dealing with holdbacks.[2]

The question in these holdback cases is slightly different from the question when does income accrue. Still, it is the right to receive and not the actual receipt of an amount which determines whether it is accruable or not; the right to receive must have become fixed before the right can be said to have accrued.[3] If the dealer does not have the right to receive amounts from holdbacks made by the finance company, if it is uncertain when he will receive them, if it is a fact that a certain percentage of these holdbacks will never be paid to him, he should not have to include them in income.

The Johnson case

Nevertheless, under these decisions, he had to do it, and the consequence was a financial problem for the dealer. He had to pay taxes on money he might never receive and had to deplete his cash in order to pay taxes on income he might receive years from now.

The more business the dealer did, the more holdbacks he had, the more pressing this cash problem.

Finally, relief came when the Fourth Circuit, on May 18, 1956, reversed a decision of the Tax Court that followed its set pattern.[4]

Blaine Johnson was a trailer dealer who financed his sales with several finance companies. Each of the agreements with those finance companies set up a holdback account. Each provided that if a retail purchaser defaulted, the finance company could charge taxpayer's holdback with the unpaid balance. A charge could be made also for any matured financial obligation, for repossession losses and other damages suffered by the finance company arising out of the contractual relationship between dealer and finance company. All the agreements provided that the ultimate balance in the account would be paid to Johnson whenever all indebtedness for which it was security had been discharged. In some agreements, the finance companies agreed to pay to the dealer from time to time any portion of the reserve that exceeded a certain percentage of the outstanding notes.

The court noted that no case involving withholdings by finance companies from automobile dealers had been decided in any circuit, though the Third Circuit had had a case of an asbestos manufacturer[5] from whom a finance company withheld a fund for the guarantee of home owners' notes. The finance company had agreed with the manufacturer to refund, out of the reserve, all amounts in excess of 10% of the notes discounted for the year and the entire amount when the relationship between dealer and finance company was terminated. Since there was no excess payable in the year at issue, the court stated that no part of the reserve was accruable as income. The court followed another case[6] in which an automobile dealer had assigned to the finance company notes given him by customers. There the reserve was less than the maximum prescribed by the agreements, and therefore no excess was payable or taxable to the dealer. In both cases, the reserve was subject to the payment of all notes discounted by the finance company. Whether the taxpayer would ever acquire a fixed right to receive anything from the reserve fund was contingent and unascertainable throughout the year in litigation.

In the *Johnson* case the Fourth Circuit took these two decisions as basis for its contention that the amount held back by the finance company is not includible in the dealer's taxable income. It considered the sale of the trailer as being inseparable from the sale of the notes to the finance company, contrary to the opinion of the Board of Tax Appeals and the Tax Court. On this point, the court noted that before the sale was completed, the customer knew which company was going to finance the transaction. The sale was one single transaction from the time the trailer was sold through the time the note was discounted by the finance company.

This means that the holdback made by the finance company has to be considered as part of the sales price to which the dealer acquires a right only if and when all the conditions of the agreement between dealer and finance company are fulfilled. If these holdbacks are released under certain conditions only, he is not required to include them in his income for the year of sale.

The decisions of the Fourth Circuit Court has been accepted by the Government. No certiorari will be requested.[7] The question of holdbacks seems to be settled.

Deferred Commissions

When to accrue those commissions the trade calls reserves is, on the other hand, far from being clear. There are several theories justifying accrual at different times. This inconsistency is due mainly to the vague and ambiguous agreements between dealer and finance company which, in effect, are no agreements at all. The finance company, in the overwhelming number of cases, gives the dealer a form letter addressed to the finance company which he signs and which is accepted by the finance company.

"We understand that you (the finance company) are to set up a reserve in our favor in amounts to be agreed upon for each transaction, and that so long as we are not in default hereunder or under any other obligation to you, you will pay to us on the first days of January, July, and October of each year, the amount of such reserve in excess of 3 per cent of the outstanding balances on the agreements purchased or acquired by you."

This "agreement" surely does not reflect all the facts. It does not say how the reserve is to be figured. It does not mention that the finance company intends to charge to the reserve a proportional reduction for any deal that is prepaid or ends in a repossession. It does not mention that the reserve can be charged with special fees for renewal deals, or for changes of the terms in any paper bought. Actually, the finance company has all the rights, the dealer none. Even if the dealer's account is credited with a reserve for a deal, he has no claim to the individual amount credited to him. He has, according to the "agreement" above only a claim to the amount exceeding 3% of all outstanding balances of notes acquired by the finance company. The reserve of each deal goes into a pool which, in turn, is called again, reserve.

It is this pool that is the object of the "agreement" as far as withdrawals

[1] 41 BTA 417.
[2] Colorado Motor Co., 41 BTA 1342; Town Motor Co., 5 TCM 625; lately William Koch Motors, 14 TCM 1322; Ray Woods Used Cars, P-H TC Mem. ¶52,878.
[3] Spring City Foundry v. Comm'r, 292 U.S. 182, 13 AFTR 1164.
[4] Blaine Johnson v. Comm'r, 1956 P-H Fed. Tax Serv. ¶72,696 *reversing* 25 TC No. 20. The Court used the same arguments this author proposed in an article, *If the Buyer Retains a Portion of the Contract Price*, Taxes—The Tax Magazine 378 (May 1954) p. 378.
[5] Keasberg & Mattison Co. v. United States, 141 F2d 163, 32 AFTR 261.
[6] Beaudry, 43 BTA 1209.
[7] 5 JTAX 141 (September 1956).
[8] Journal of Accountancy 330 (October 1950).

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are concerned, not the reserve of an individual deal. Since the total of the outstanding customers' notes changes every day, if not every hour of the day by repayments and new acquisitions, the dealer's right is not only not fixed as far as the individual reserve is concerned; it is not fixed for the pool. The dealer has only the right to the excess reserve over 3% of the outstanding customers' accounts. This total is fluctuating, but it can be stated at the end of each business day.

If this differentiation between individual reserve and pool is not made, the taxability of reserves to the dealer will remain in a controversial state. At present, the Commissioner and the Tax Court seem to have adopted the position that the individual reserve is taxable as soon as it is credited to the dealer's pool. In practice, most dealers report income whenever they receive payments from the finance company; in this way, they don't pay taxes for a mere entry on the books of the finance company.

The *Johnson* case is, in every respect, a rejection of the Commissioner's method of taxing reserves. If holdbacks arising out of the purchase of installment paper need not be accrued, commission reserves contingently credited to the dealer and given to him as an inducement, and not as a matter of vested right, cannot establish a fixed right and are therefore not accruable at the time of credit. At most, the dealer has a claim to the excess over 3% of the outstanding customer balances.

On the other hand, including reserves in taxable income only when they are received by the dealer does not seem to be in accord with the concept of accrual. This would be a clear and precise reversion to the cash method. No circuit court has, so far, dealt with this specific problem of reserves. Since this author first recommended reporting the excess over 3% of all outstanding customer accounts on the books of the finance company[8], no authoritative opinion has been published that deals with the problem. It is known that there was a directive to agents not to overlook reserves, and the indications are the Commissioner still adheres to his position that the dealer has income immediately upon credit to his account. In the wake of the *Johnson* case which has been more or less accepted by the Commissioner, it is only logical to assume that the problem of reserves will be analyzed anew. ☆

Receipts later refunded bring tax burden when less than $3,000; escrow may help

THOMAS ROSENBERG'S experience with a contingent fee, later repaid, is a cruel tax lesson for the practitioner about to collect such a fee. Suppose you, as was Mr. Rosenberg, were in this situation:

You get the money, report it in your tax return and pay the taxes thereon; later, because of your moral obligation, if not a legal one, you repay to your client the full amount of the fees received in the prior year. If the fee was $10,000 and you are in a 50% bracket, you have received net only $5,000 but you must repay $10,000. How do you get back the taxes paid?

Code Section 451(a) is substantially the same as 1939 Code Section 42(a). The general rule provides that you must report gross income in the taxable year in which it is received, unless under your method of accounting in computing taxable income it is proper and more accurate to report it in some other accounting period.

Under the 1939 Code, attorney Thomas Rosenberg et al. received monies paid to them as legal fees in obtaining refunds of taxes from the State of Illinois after they won suits in the lower courts of the state. Subsequently, the State of Illinois brought suit to recover the amounts which had been refunded to the client of Mr. Rosenberg. The Supreme Court of Illinois reversed the lower court and forced Mr. Rosenberg's client to repay to the State of Illinois the amounts previously paid to them under the lower court's order.

Mr. Rosenberg, rendered legal services to his client under a contingent-fee contract, and after the State of Illinois had paid the refunds to the client, it paid Mr. Rosenberg the agreed amount of legal fees. See TC Memo 1956-68 March 22, 1956.

The Commissioner of Internal Revenue says that Mr. Rosenberg owes the income tax on the fees received in 1949, regardless of the fact that they must be repaid to his client. The Tax Court says that the Commissioner is right and that Mr. Rosenberg should include in his gross income for 1949 the legal fees received under the contingent-fee contract because such fees were received under a "claim of right" without restrictions. The Tax Court similarly held in another Illinois case under almost identical circumstances, *Michael Phillips et al.*, 25 TC No. 89 January 17, 1956. However, the taxing authorities have conceded that the repayment of the legal fees will entitle the taxpayer to a deduction in the year of repayment.

This situation may be avoided in a simple and legal manner: by having the monies due to you paid over to an escrow agent, to be held until all contingencies have been definitely removed. When you receive such amounts without restrictions, and without any danger of having to refund such amounts, then you report the amounts as income.

Even though you are permitted to take a deduction for a repayment of fees of this nature in the year of repayment, the rub comes because of a difference in the amount of taxable income, the bracket you are in, and the total excessive tax cost to you. Or if you are very lucky, the deduction may fall in a year when you have much more income, when you may really enjoy the benefit of the deduction. Whether or not there is a contest over which year the income must be reported is entirely dependent upon the costs to you or the benefits to you under the adjustments proposed by the Internal Revenue Service.

If the fees you have received under contingent contracts are less than $3,000 for each engagement, the decisions above are still of great importance. However, if you are fortunate enough to be among those whose single-fee billings are in excess of $3,000, then you may find relief in the 1954 Code.

There is relief if fees are substantial

Entirely new in the 1954 Code is a relief section which provides the rules for the computation of tax where the taxpayer restores a substantial amount held under a claim of right.

Subchapter Q, Part V, Section 1341

of the Internal Revenue Code does something for the taxpayer who is fortunate enough to have clients who will pay billings for fees in excess of $3,000; provided, however, that you are required to repay to your client such fees because you mistakenly held the fee, after payment to you, under a claim of right.

If you have received money for a fee in excess of $3,000 under the mistaken idea that you had an unrestricted right to the money and it is established after the close of the year in which you received the fee that you must repay it, then you will be entitled to a deduction in the year of repayment. But, in addition to the deduction, there will be a recomputation of the income taxes due by you, both in the year you repay the money to your client and in the year you erroneously included such money (fee) in gross income. Under the two methods as laid down in the rules, the amount of tax computed, which is smaller is the amount of your tax liability for the year in which repayment is made. Subsection (a) provides the general rules and subsection (b) the special rules.

No relief for fees under $3,000

This is indeed a harsh and inequitable rule for the majority of attorneys and certified public accountants who have billed fees of less than $3,000 for services which are in some respect dependent on some contingency, and because of such contingencies may have to be refunded to the client. The limitation of $3,000 should be removed, and the computations provided in paragraphs (4) and (5) should be applicable regardless of the amount involved. ☆

New case on salvage exceeding book value may not hold up

TAX PRACTITIONERS know that revenue agents are very fond of the argument that if depreciable property is sold for more than its book value, the depreciation deductions were necessarily wrong. This was an issue in *Pilot Freight Carriers, Inc.*, [see page 287], which is being widely commented on. As we see it, however, the case may have little value as a precedent, because the court held that the parties excluded one important element in the computation. It found that their stipulation narrowed the issue so as to exclude any question of the salvage value used by the company. It had figured depreciation on its truck trailers on the basis of a useful life of both trucks and trailers of four years and remaining salvage value of 10% of cost. The court found the life of truck tractors was four years and of trailers, five years. It then went on to discuss the inference to be drawn from the fact that on disposition the sales price or trade-in allowance was in excess of book value. You will note that court seems to imply that if the salvage value estimate were before it, it might have changed that factor in taxpayer's depreciation formula. Here's what the Tax Court had to say.

"A part of the respondent's argument on brief in effect is that the petitioner must have understated the length of the useful life of its tractors and trailers in view of the fact that upon disposition thereof, both by sale and upon exchange for new equipment, it received amounts largely in excess of the depreciated cost thereof. This, however, does not necessarily follow. In *Weir Long Leaf Lumber Co.*, 9 TC 990 reversed on other issues, 173 F.2d 549, we stated in part:

" 'The sole fact therefore in any specific situation that a given price is received for articles not fully depreciated throws no light on the effect upon the depreciation allowance. *Thomas Goggan & Bro.*, 45 BTA 218. If a higher price was available for their automobiles because of a miscalculation as to their useful life, a different result would follow from an enhanced sale price due to appreciated values. . . . The depreciation deduction can not be disallowed merely by reason of the price received for the article without consideration of other factors.'

"*Thos. Goggan & Bro.*, involved the trade-in of a used automobile on the purchase of a new automobile. We stated:

" 'Certainly, the amount of the trade-in value allowed on an automobile which has been used in a trade or business for a given period can not be said to determine the amount or the rate of the depreciation to be allowed on it in any year of its use.'

"In the instant case it has been shown that the prices received by the petitioner upon disposition of its used equipment were higher than their depreciated cost principally because of the shortage of such equipment during and following World War II and the Korean conflict, and the fact that consequently the prices of both new and old equipment had increased. Furthermore, it has also been shown that amounts received upon trade-ins were not truly representative of the value of the equipment, but rather were artificial figures resulting from price concessions made by the new equipment dealers. Under the circumstances of the instant case, it is clear that the fact that the petitioner received upon disposition of its used equipment amounts in excess of depreciated cost does not indicate that such equipment had a longer useful life in the petitioner's business than claimed by the petitioner. If there was error in the petitioner's estimates of salvage value, correction thereof cannot be made by changing the rate of depreciation based upon the useful life of the property in the petition's business. Each factor in the depreciation computation is to be separately considered and adjusted if it appears at the end of the taxable year that it is erroneous." ☆

Shortcut worksheet for sum-of-the-years-digits depreciation

OF THE TWO NEW rapid depreciation methods permitted under the new Code, declining balance has been more popular (see 4 JTAX 16). According to William H. Wolfe, Jr., staff accountant with Maddrea, Fergusson & Woody, Richmond, Va., accounting firm, this is so because it is considered to be easier to work with. Mr. Wolfe worked out (in *The Virginia Accountant*) a simplified method for computing depreciation by the sum-of-the-years-digits methods which ought to encourage those who want to use it but don't quite know how to do so easily. This is what he does:

Example

Assume a calendar-year taxpayer acquires a new asset on January 1, 1954, at a cost of $5,000.00, with a useful life of five years. (No particular problem arises where an asset is purchased on the first day of the year.)

	Cost	Fraction	Depreciation
1954.....	$5,000.00	5/15	$1,667.00
1955.....	5,000.00	4/15	1,334.00
1956.....	5,000.00	3/15	1,000.00
1957.....	5,000.00	2/15	666.00
1958.....	5,000.00	1/15	333.00
			$5,000.00

But this is usually the exception rather

EXHIBIT I

		Depreciation
1954:	$7/12 \times 5/15 \times 5{,}000$ =	$ 972.00
1955:	$5/12 \times 5/15 \times 5{,}000 + 7/12 \times 4/15 \times 5{,}000$ =	1,473.00
1956:	$5/12 \times 4/15 \times 5{,}000 + 7/12 \times 3/15 \times 5{,}000$ =	1,139.00
1957:	$5/12 \times 3/15 \times 5{,}000 + 7/12 \times 2/15 \times 5{,}000$ =	806.00
1958:	$5/12 \times 2/15 \times 5{,}000 + 7/12 \times 1/15 \times 5{,}000$ =	471.00
1959:	$5/12 \times 1/15 \times 5{,}000$ =	139.00
		$5,000.00

EXHIBIT II

Year	Cost	Denominator	Numerator	Depreciation
1954	$5,000.00	180	35	$ 972.00
1955	5,000.00	180	53	1,473.00
1956	5,000.00	180	41	1,139.00
1957	5,000.00	180	29	806.00
1958	5,000.00	180	17	471.00
1959	5,000.00	180	5	139.00
			180	$5,000.00

than the rule. Consider the same facts except that the date acquired is June 1, 1954. We can see that depreciation is computed as shown in Exhibit I.

By 1959 the accountant's work papers will look like a Chinese newspaper, and this may be one reason why the above method is not utilized quite so often as the other more popular methods.

Now let's try another angle. By converting the fractional figures into multiples of twelve (thus months instead of years) the problem simplifies itself.

Note that the total of the numerators must equal the denominator. The attractive feature is that after the second year *the numerator need not be computed* since it will always decrease by twelve. Assume the same circumstances as before. The computation is shown in Exhibit II.

Computation of denominator

Years	Months
5×12 =	60
4×12 =	48
3×12 =	36
2×12 =	24
1×12 =	12
Denominator	180

Computation of numerator

$7/12 \times 60$ =	35 First Yr.
$5/12 \times 60 + 7/12 \times 48$ =	53 Second Yr.
$5/12 \times 48 + 7/12 \times 36$ =	41 Third Yr.
$5/12 \times 36 + 7/12 \times 24$ =	29 Fourth Yr.
$5/12 \times 24 + 7/12 \times 12$ =	17 Fifth Yr.
$5/12 \times 12$ =	5 Sixth Yr.
Numerator	180

Fast depreciation not widely adopted; possible EPT, accounting problems ensue

Because of the significant tax-saving incentive to the adoption of the 200% declining balance method and the sum-of-the-years-digits methods of depreciation permitted by the new Code, it is surprising that more taxpayers have not adopted the new methods, says Albert Cohen (in a recent speech), director of taxation, American Institute of Accountants. [Since moved to Price Waterhouse & Co. *Ed.*] Both new methods, of course, allow deduction in the early life of an asset of a much greater portion of the cost than was possible heretofore.

"Since many taxpayers follow the bird-in-the-hand philosophy," says Mr. Cohen, "we might have expected an almost unanimous adoption of the new methods. Rather surprisingly, however, only approximately 30 to 40% of the eligible property is being so depreciated. The reasons for this are not entirely clear but perhaps there is something to indicate that taxpayers are not always guided by the bird-in-the-hand philosophy, and may be swayed to a more conservative approach to claiming deductions when circumstances warrant."

As Mr. Cohen explains it, in late 1954 and in early 1955 the international situation was still somewhat unsettled, and a new Congress was being organized. Many taxpayers apparently felt that international and domestic events might create a new situation in which an excess-profits tax might be needed. If there was an excess-profits tax, say, in 1958, a taxpayer who had elected declining-balance or sum-of-the-digits depreciation in 1954 might be in an extremely distressing position.

In 1958 the undepreciated cost of the properties acquired in 1954 and in 1955 would be considerably lower than if straight-line depreciation had been used, and the depreciation in a 1958 excess-profits-tax computation would be correspondingly lower. This result, in itself, is somewhat of a deterrent. If 1954 happened to be an excess-profits-tax base year, taxpayer distress would be magnified by the low income in 1954 by reason of accelerated depreciation. Perhaps these grim possibilities kept many taxpayers from utilizing accelerated depreciation.

Now, however, we may find more taxpayers electing accelerated depreciation, and significant problems will appear. Without doubt, accelerated depreciation was viewed as an economic incentive to investment. In fact, the new methods are limited to assets acquired after December 31, 1953, to provide a stimulus only to the creation of new assets. Nevertheless, the Finance Committee went out of its way to make the observation that "the liberalized declining-balance method included in the bill concentrates deductions in the early years of service and results in a timing of allowances more in accord with the actual pattern of loss of economic usefulness. With the rate limited to twice the corresponding straight-line rate and based on a realistic estimate of useful life, the proposed system conforms to sound accounting principles."

AIA agrees

We think that the view propounded by Mr. Cohen is confirmed mildly by Accounting Research Bulletin No. 44 of the Institute's committee on accounting procedure. In that bulletin the committee observes that since declining balance has a long history of use in England and in other countries and meets the requirement of being systematic and rational, it may well provide the most satisfactory allocation of cost for assets whose expected pro-

ductivity or revenue earning power is relatively greater during the early years of life or where maintenance charges tend to increase during the later years. Thus, accelerated depreciation is tagged officially as sound accounting, and has received the approval of the accounting procedure committee.

A problem may arise, however, where the financial statement for non-tax purposes does not use the same method of depreciation as is used in preparing the tax returns. Certainly the availability of accelerated methods for tax purposes does not invalidate whatever method had been used in the past.

Simultaneous use of both methods

This poses the fundamental question as to whether, where there are two generally accepted methods, one that may honestly be used for tax purposes and the other for non-tax purposes. In the case of depreciation, this problem is further complicated since the new tax methods apply with respect to assets acquired new after 1953. In financial statements for 1954 and later years, substantially identical property acquired prior to 1954 may be treated differently from that acquired subsequent to 1953; yet in both cases, the accountant will be stating that income has been fairly presented. The reconciliation of these differences presents a real challenge to the profession and is one which should be dealt with.

One possible answer to the problem is suggested by Accounting Research Bulletin No. 44, which notes declining balance may be adopted for tax purposes but other appropriate methods followed for financial purposes if the accelerated depreciation method less fairly presents the results of operations than a method which is actually used. Under these circumstances, there is a strong implication that the accelerated tax method is purely an economic incentive rather than a more realistic method of accounting.

If this is the case, it certainly should be recognized. Accountants must distinguish very carefully between legitimate accounting methods of determining income and legitimate tax methods of establishing economic incentives. Where accelerated depreciation is primarily a tax incentive, valid reason exists for using different methods for financial accounting purposes and tax purposes. Where the amount involved is material, however, appropriate accounting recognition of the deferred income taxes should be accorded. In fact, two members of the accounting procedure committee felt that wherever an accelerated method was used for tax purposes but not for general financial purposes, such accounting recognition should be given. ☆

Treasury wants to close loophole through which co-op distributions escape taxation

RECENT COURT DECISIONS have opened a major loophole through which co-ops are escaping taxation. Co-ops now can allocate or credit their earnings to the account of their members, instead of paying them cash dividends. The co-op issues so-called "certificates of beneficial interest," a sort of note bearing no interest and no payment date. In this way the co-op supposedly distributes its earnings, but it still keeps them for current and expansion uses. The co-op which follows this procedure incurs no tax on its earnings. And the members and customers who receive the notes also do not receive taxable income, according to the courts. The earnings of the co-op therefore are completely tax-free.

The Administrations says that this is not what the 1951 law intended. Under that law, co-op earnings were to be taxed to either the member who drew a patronage dividend or to the co-op which kept the earnings. The loophole which now exists in the law, says the Administration, is driving out of business competing firms which must pay tax.

To accomplish the purpose of the 1951 law, Secretary of the Treasury Humphrey suggests that co-ops take deductions in computing their taxable income only for "(a) cash distributions and (b) noncash allocations issued in such form or under such circumstances as would make them currently taxable to the patron members receiving them."

He also suggests that tax withholding be applied by the co-ops to the payments they make to patrons and members. To this proposal, the farmers' co-ops counter with the argument that they make small cash payments every year to hundreds of thousands of farmers who are not required to file tax returns because they do not have enough taxable income. Moreover, they say, the bookkeeping problems will be tremendous.

Because of the strenuous objections, it appears that the withholding proposal will not be adopted. But the proposal to close the loophole bears watching; even though it did not pass in this last session, other attempts will follow. ☆

Effect of tax payments on business studied

THE BUSINESS of paying taxes imposed on a business, aside from the more usual questions of determining amount of the liability, has been investigated by Horace J. DePodwin, Professor of Economics at Rutgers. In a small volume just published (by the Rutgers University Press), he explores the effect of such payments on, among other things, working capital, accounting for tax liabilities, financing of tax payments, and acceleration of corporate payments under the 1954 Code. While this report is of primary importance to economists and public finance scholars, it does have important implications for the taxpayer in the sense that the manner of payment often may be as important as the amount of tax or the tax rate. ☆

Tulane Tax Institute to be November 14-17 this year

WE'VE JUST received word from Peter Firmin that the Tulane Tax Institute this year will be held at the St. Charles Hotel, New Orleans, November 14-17. Registration fee: $50. Details from Mr. Firmin, Tulane University, New Orleans. ☆

New accounting decisions this month

Common stock and warrants substantially identical if relative values similar. If an individual taxpayer who is not a dealer in securities sells common stock at a loss and simultaneously purchases common-stock warrants of the same corporation, the loss is not allowed under the wash sales rules. If he sells

stock warrants at a loss and simultaneously purchases the common stock, the loss is allowable unless the relative values and price changes are so similar as to make the two substantially identical. The reason is that a warrant acquired at the time of sale of the stock is an "option," and the wash sales provisions apply to options acquired within a month of the sale. However, when warrants are sold and stock bought, the provisions of the 1954 Code covering short sales of property when substantially identical property is held will apply if as a matter of fact the stock and the warrants are substantially identical. *Rev. Rul.* 56-406.

CAPITAL GAINS

FHA "windfall" profits capital (old law.) This headlined case has an interesting sidepoint regarding capital gain and ordinary income. The taxpayers were stockholders of several corporations organized to build and operate housing projects financed by FHA-insured mortgages. The mortgages on the property were greater than the actual cost of construction. The stockholders received a cash distribution of the difference between the loan and construction cost. The Commissioner claimed that the distribution was a fully-taxable dividend because it did not impair the capital of the corporation. In the Tax Court proceedings, the *Godley* and *Hirshon* cases were cited in support of the proposition that if a corporation's earnings and profits were sufficient to cover the cost of the property distributed in kind the entire value of the property is taxable. The Tax Court rejected this argument and held that the distribution was to be applied against the basis of the stock and any excess was taxable as capital gain.

On appeal, the Commissioner argued that the windfalls were "gain or profits and income derived from any source whatever," that they were in effect an anticipation of future profits due to economies in construction and operation. The court rejects the argument that such unrealized items can increase the corporate earnings so as to make distributions taxable.

One dissent by Judge Clark. He reviews current criticism of the erosion of the tax base by permitting business profits to be treated as capital gain; he would decide this case on the equities; the real situation is that the builders realized a gain through their business operation. [Section 312(j) of the 1954 Code closes this loophole for distributions made after June 22, 1954, by treating the proceeds of U. S.-insured loans as "earnings and profits" to the extent they exceed the basis of the property mortgaged. *Ed.*] *Gross*, CA-2, 8/29/56.

Rental properties received on liquidation of building corporation were for investment. Taxpayer, an insurance agent, was also 48% owner of a corporation engaged in construction of rental housing under FHA. He bought six houses from the corporation and received 13 more upon its dissolution. He sold them and the building in which he carried on the insurance business in 1946 and 1947 preparatory to retirement. The court finds that the properties were held for investment; the gain is capital. *Rylander*, DC Calif., 7/24/56.

Builder of houses both dealer and investor. To determine whether a builder held houses for sale in the ordinary course of his business (ordinary income), or for rental-investment purposes (capital gain on sale), the court considers the following factors: the purpose of acquisition; the substantiality, frequency and continuity of sales; the nature and extent of taxpayer's business; the activity of the taxpayer and those acting for him; and the treatment of the property in the taxpayer's records. The court concludes that installment gains from 1945 and 1946 sales of houses sold upon completion were ordinary income, but houses sold in 1947 and 1948 after having been rented prior to sale, were incident to a liquidation of property held for rental-investment purposes. *Bradley*, 26 TC No. 124.

Though store was operated for six months, not proved goodwill was six months old. After taxpayer had operated his men's haberdashery business as a going concern for more than six months, he sold it for a price exceeding the basis of its assets. He said the excess was "locational goodwill." The Commissioner said it was prepayment for services or short-term gain on goodwill, in any event fully taxable. Because of the relatively short time the business was in existence, the court is unable to find that the goodwill existed as a business asset for more than six months prior to sale. It usually takes time to develop the extraordinary earning power which is goodwill. In the absence of evidence by the Government, the court also upholds taxpayer's valuation of the stock received based on the corporate book net worth. The court allows an ordinary loss on the sale of inventory to the buyer of the business at cost less a flat discount of $3,000. *Friedlander*, 26 TC No. 130.

Capital gain on transfer of contract rights back to grantor; it was a sale, not mere extinguishment. In 1944, taxpayer acquired the right, irrevocable for ten years, to purchase all of the coal from mines in a certain area owned by the other. In 1949, taxpayer received $500,000 from the mine owner to whom it assigned "all our . . . interest in the agreement dated . . . 1944." The Commissioner contended the receipt was ordinary income because the contract was not a capital asset and was not "sold or exchanged." The Tax Court holds that the contractual right was a capital asset; the 1949 agreement did not merely extinguish it. Where the property continues to exist as property of the transferee-payor, there is a sale. The transferee-payor here (the mine owner) acquired the right to sell its coal to whomever it chose, a right it did not possess from 1944 to 1949. *Pittston Co.*, 26 TC No. 123.

Stock purchased to acquire assets; no gain on liquidation. [*Acquiescence*] Taxpayer was able to acquire assets of another corporation only by buying its stock. This it did, and then it liquidated. The Tax Court held there was no gain on the liquidation because the formal purchase of stock was in reality a purchase of assets. [The 1954 Code specifically makes this type of purchase and liquidation tax-free. *Ed.*] *Snively*, 19 TC 850, *acq.* IRB 1956-32.

Lawyer has ordinary income on real-estate deals. During a period of 18 years, taxpayer and his law partner engaged in real-estate transactions. The court holds they engaged in the business of buying and selling land, though this was not their principal occupation. It follows that the lots sold had been held primarily for sale to customers and that the gain is ordinary. *Skopil*, DC Oreg., 7/11/56.

No capital gain on pulpwood cut by contractor from felled tree tops and limbs. Section 631 benefits (providing

for capital gain and ordinary loss treatment) are applicable only to the disposal of standing trees (timber) held for more than six months before disposal under a contract whereby an economic interest is retained. The benefits do not apply to the income received from the sale of pulpwood extracted from the tops and limbs of trees felled by the owner, since there has not been a disposal of "timber." *Rev. Rul.* 56-434.

Speculator's losses on commodities and futures are capital. Taxpayer, who bought and sold commodity futures, devoted 70% of his time to this activity. The 400 trades he made in 1950 totaled over $17 million. He had seats on two exchanges. He also traded in actual commodities. The court holds that the activities were speculative, in no way incidental to a trade or business, and that neither the commodities nor the futures were held for sale in the ordinary course of a trade or business. The losses on sale of the futures, as well as the commodities, were capital losses. *Flora,* DC Wyo., 7/24/56.

Capital gain on breeding cattle; ordinary income on culls slaughtered. In a brief oral decision, the court finds that the herd on one ranch was primarily a breeding herd; sales of culls there were not in the regular course of business and the animals had not been held for sale to customers. Gain is therefore capital. However, culls sent to another location for slaughter were held for sale to customers. Gain on such sales is ordinary. *Kahua Ranch, Ltd.,* DC Hawaii, 8/2/56.

Loss on butter futures ordinary loss to cheese dealer. The court allows a loss on closing out butter futures contracts in full as a hedging transaction. It finds that the futures were sold to protect taxpayer, a cheese and egg wholesaler, against his cheese commitments. *Kurtin,* 26 TC No. 121.

INVOLUNTARY CONVERSION

Sale of part of home lot to pay assessment not an involuntary conversion. To pay for an assessment for paving the streets, taxpayer sold a portion of a city lot on which his residence was located. This sale is neither the sale of a principal residence (on which gain is not recognized if a new home is bought) nor an involuntary conversion. The amount of gain realized is therefore currently taxable as capital gain. *Rev. Rul.* 56-420.

Destruction of mineral rights by flooding for new dam is an involuntary conversion. Payments received as compensation for mineral rights in certain Oklahoma and Texas lands which were inundated in 1945 as part of the Denison River Dam and Texoma Lake Project constitute an involuntary conversion of property into money. *Rev. Rul.* 56-436.

DEPRECIATION & DEPLETION

Increase in salvage doesn't necessarily require change in depreciation. The average useful life of line-haul tractors and trailers was determined to be four and five years respectively as claimed by taxpayer, a motor-freight transportation company. The fact that upon disposition of its used equipment taxpayer received amounts in excess of depreciated cost did not indicate that such equipment had a longer useful life. Here the larger amounts were due to shortages of equipment during the Korean war. If there was error in the estimate of salvage value, correction thereof could not be made by changing the rate of depreciation. [See comment, page 283.] *Pilot Freight Carriers, Inc.,* TCM 1956-195.

Must amortize premiums to general (not contingent) redemption price (1939 Code). The election to amortize the premium paid on the 1953 purchase of bonds redeemable prior to maturity on 30 days' call either at a general redemption price or at a lower "special" redemption price should be made with reference to the general redemption price if contingencies preclude reasonable advance ascertainment of a call at the special redemption price as to any particular bonds. [The provisions of the 1954 Code denying amortization on bonds issued after 1951 and acquired after 1950 to a call date within three years of insurance do not apply to those bonds acquired in 1953. *Ed.*] *Rev. Rul.* 56-398.

Income from nonproducing activities affect percentage-depletion limitations. In determining the treatment to be accorded nonproducing activities (i.e. operation of company store) under the percentage depletion limitations, the method of operating the activity is controlling. Where taxpayer operates the nonproductive activity as a business for profits, the activity is to be separated and excluded from the gross income and the taxable income used in computing the percentage limitations; but where the activity is not motivated by profit, it is an indirect increase in wages and salaries of production employees and is therefore required to be taken into account in making depletion computations. *Rev. Rul.* 56-433.

Percentage depletion available for pulverized limestone. In crushing rock for chemical-grade limestone and crushed-rock products, the production of pulverized limestone as a byproduct from the primary and secondary crushing will be treated as part of the "ordinary treatment processes" for depletion. The pulverization of limestone for making agricultural limestone will be excluded. *Rev. Rul.* 56-405.

ACCOUNTING METHODS

Cemetery's voluntary increase in payment to trust for care not deductible. Taxpayer, a cemetery association, had entered into a trust agreement in 1918, providing for annual payments to provide payment for perpetual care. These payments did not produce enough income for maintenance. Therefore, taxpayer paid an additional $10,000 to the trust. The court holds this is nondeductible. There is no current expense, nor is this like the annual payment, the turning over of funds impressed with a trust. *Fairmount Cemetery Association,* DC Colo., 7/24/56.

January inventory price indexes published. Price indexes for January 1956 published by the Bureau of Labor Statistics on 3/6/56 for use by department stores employing retail and Lifo inventory methods are acceptable to the IRS. *Rev. Rul.* 56-402.

Later change doesn't affect down payment; installment method allowed. On December 30, 1947, taxpayer and her family members sold all their stock to a corporation for $110,000, $50,000 in cash and $60,000 in notes). Taxpayer's share was $85,000—all of the notes plus $25,000 cash. It was however agreed at that time that the debt of one seller to the corporation would be paid. Early in 1948, the corporation set off a debt of $11,000 due from one of the family members against the notes, thereby making available retroactively to tax-

payer an additional $11,000 in cash. The Commissioner argued that this increased the 1947 down payment to more than 30%; hence, taxpayer couldn't use the installment method. The court holds the "initial payment" in 1947 was the original $25,000 and, since it was less than 30% of taxpayer's selling price, she was entitled to report the gain on the installment basis. *Ebner,* 26 TC No. 122.

Lose right to lifo; didn't show stockholder reports were consistent. The Code requires as a condition for using lifo that all reports to stockholders be on the same basis. The court finds taxpayer not entitled to lifo because it failed to prove that its reports to stockholders were based on lifo. The reports to stockholders stated that inventories were valued at the lower of cost or market. The taxpayer claimed that contingency reserves on the stockholders reports amounted to valuing inventory at lifo. *H. C. Goodman Co.,* DC Ohio, 7/13/56.

BAD DEBTS

Produce dealer's advances to banana shipper are business debts. In order to ensure a supply of bananas for his produce business, taxpayer invested in a navigation company formed to engage in the banana trade with Cuba and Central America. Advances of some $16,000 to the company were held to be incidental to and proximately related to taxpayer's produce business. The resulting bad debt loss was deductible in full as a business bad debt. *Dorminey,* 26 TC No. 118.

SEIDMAN RECEIVES AIA AWARD

THE AMERICAN INSTITUTE OF ACCOUNTANTS' 1956 award for outstanding service to the accounting profession was presented to J. S. Seidman, New York CPA, at the Institute's annual meeting in Seattle, Washington, on September 25.

Mr. Seidman, who often appears in these columns as author or commentator, is a vice president of the Institute and for the past three years has been chairman of its committee on federal taxation. Mr. Seidman is author of the four-volume *Legislative History of Federal Income and Excess Profits Tax Laws,* and is Tax Columnist for the *New York Herald Tribune.* ☆

Bad debts not attributable to any business. Losses were sustained by the taxpayer as the result of the uncollectibility of various advances to two corporations engaged in the timber business. He had helped organize and operate them, but the loans were nonbusiness bad debts because taxpayer was not in the business of lending money or organizing and financing corporations. *Bradley,* TCM 1956-189.

Loan to nephew to start in business a nonbusiness bad debt. Taxpayer, a real-estate dealer and investor, loaned money to his nephew on a mortgage to enable him to rent, equip, and stock one of taxpayer's vacant stores as a grocery. The bad debt resulting from the loan is held not to be incidental or proximately related to taxpayer's business, and was therefore not allowable as a business deduction. *Bradley,* 26 TC No. 124.

OTHER DECISIONS

Executor doesn't realize income or make gift by waiving commissions. Before rendering services, an executor waived his right to receive full commissions and agreed to take a commission less than that allowed under state law. The Service holds that the difference between the full allowable commissions and the amount agreed upon is not income constructively received; he has committed no action implying acceptance or ownership of the full amount. Nor is the waived portion a gift (presumably to the estate or the residuary legatee). *Rev. Rul.* 56-472.

Contractor can't deduct civil damages to U. S. Taxpayer was denied a deduction for a sum paid the U. S. as double damages on a judgment rendered against him and arising out of a civil action for knowingly presenting false claims. He conceded he could not deduct the $10,000 penalty, but he argued the double damage was compensatory to the Government and that therefore an adjustment of his income was necessary. He had contracted to deliver fresh milk to an army air base but had actually delivered reconditioned and recombined milk. The court holds sound public policy forbade the deduction for the damages, as well as the attorneys' fees and other expenses incident to the litigation. *Faulk,* 26 TC No. 119.

Fixed mineral lease payments are advance royalties deductible by payor. Taxpayer was the assignee of a lease under which it paid in addition to stated royalties, $300,000, payable $7,500 a quarter for the ten-year period of the lease. Taxpayer contended the quarterly payments were deductible as lease rentals, or if not, then as bonuses or advance royalties. The Government maintained that such payments were payments for the lease and recoverable only through depletion. As the taxpayer was entitled to percentage depletion, increasing the capital costs would not affect its depletion deductions. The district court held that the payments were advance royalties and since they were admittedly depletable income to the recipient, the lessor, they are deductible advance royalties to the taxpayer lessee. This court affirms. *Jefferson Lake Sulphur Co.,* CA-5, 9/6/56.

Severance of joint tenancy or conversion to tenancy in common nontaxable. The conversion, for the purpose of eliminating a survivorship feature, of a joint tenancy in capital stock into a tenancy in common, or the severance of a joint tenancy under a partition action is a nontaxable transaction. It is not a sale or an exchange. *Rev. Rul.* 56-437.

Salary from insolvent company is income despite offsetting claims. Taxpayer reported as income his 1944 salary from a corporation of which he was the sole stockholder. The court holds this is correct; the money was received under a claim of right. It is irrelevant that subsequently it was found that the corporation was insolvent in 1943 as a result of the excessive salary paid to the taxpayer. The excessive salary for 1943 was disallowed as a deduction, and taxpayer paid the corporation's tax because it was held that he was liable as transferee. *Smith,* DC Ohio, 8/22/56.

Sole owner permits wife and son to buy new stock; their large dividends taxed to him. Taxpayer owned the common stock of United Business Service (investment reports); relatives owned the preferred. In 1935, the corporation issued a new nonvoting stock and sold it for $5,000 from his wife and $5,000 from a trust he created at this time for his son. Over the next ten years, $185,000 was paid in dividends on this $10,000 investment, preferred received some $14,000 on its $25,000 investment, and common $168,000 on $75,000 invested. The court holds the 1943 and 1944 dividends tax-

able to the father; the "purchases" for $10,000 were in facts gifts and anticipatory assignments of income; the issuance of stock had no business purpose. *Babson,* DC Mass., 7/16/56.

Group insurance on commission salesmen taxable to non-employees. Premiums paid for group life and hospitalization insurance on commission salesmen are deductible as business expenses whether or not an employer-employee relationship exists, provided the taxpayer is not a beneficiary. Salesmen who are employees need not include the premiums in their income unless paid for group permanent life insurance; nonemployee salesmen are taxable on such premiums. *Rev. Rul.* 56-400.

Payments for grain stored was income, rather than loan; fraud sustained. Taxpayer omitted from his 1943 and 1944 returns certain checks which he claimed were loans on grain stored—not proceeds of sale. He paid the deficiencies and fraud penalties for 1943. The jury finds that the 1943 checks were income and sustains the fraud penalty; those for 1944 were not. *Carter,* DC Tex., 7/20/56.

Earnings taxed to earner, not his assignee. In 1932, taxpayer assigned his insurance commission contract to his wife. The court says this case is identical with *Eubank* in which the Supreme Court held that an insurance agent could not avoid tax on income already earned by assigning it to another. *Hall,* DC Ind., 8/2/56.

Rebate of insurance premiums accrued when right became fixed, though policyholder didn't know it. Taxpayer's group life war risk policy called for equal apportionment of the divisible surplus among policyholders annually. No such distributions were made until 1947 when taxpayer received $50,000. It had no knowledge, prior to actual receipt of the refund, of the insurer's decision to distribute the surplus existing at September 1, 1946 or of the amount. Taxpayer included the refund as income in the year received; the Commissioner held it accrued in 1946. The court, in denying a claim for refund based on a net operating loss carryback to 1944, holds that income accrues when the right to receive it becomes certain. That was 1946; taxpayer's ignorance of the decision in 1946 is irrelevant. *Harrisburg Steel Corp.,* DC Pa., 7/12/56.

Unrecognized gain upon corporate liquidation does not reduce net operating loss. A corporation sustained a net operating loss for a taxable year in which it sold its corporate assets as part of a plan of complete liquidation at a gain. However, the gain was not recognized under the provisions of Section 337. The Service holds net operating loss, net operating loss deduction, and carryback are all to be computed without adjustment for the unrecognized gain from the sale of the assets. *Rev. Rul.* 56-448.

Inactive owner of real estate doesn't have operating loss. Taxpayer owned a building which was foreclosed by the first mortgagee. She claimed a net operating loss carryover, which the court disallows because she had not operated a business. She had only collected the income from agents who actually managed the property. *Dunlap,* DC NY, 7/10/56.

No "tax benefit" when standard deduction used. A recovery of state income taxes need not be included in income under the tax benefit rule if in the year of the state income tax payment taxpayer had elected to use the tax table or the standard deduction. *Rev. Rul.* 56-477.

Loss on liquidation of business not operating loss (old law). Taxpayer who was employed as an executive also owned and operated a chicken hatchery. A loss from complete liquidation of the business in 1952 was held attributable to the "termination" rather than the "operation" of the business. The loss was a non-business loss which could not be used to offset taxpayer's salary so as to create a net operating loss in 1952 giving rise to a net operating loss deduction in 1951. [Under present Code a loss on liquidation of a business would qualify as a net operating loss. *Ed.*] *Overly,* TCM 1956-197.

Par of stock issued for assets accepted as 1913 value. Taxpayer was organized in 1913 to build and operate a theater in Brooklyn. It issued 750 shares of $100 par value stock in exchange for three assets acquired in a package deal: (1) a contract to buy a theater site; (2) plans and specifications for the theater; (3) a Keith franchise to obtain "big time vaudeville." In 1934, taxpayer sold the theater and its other assets with the exception of the Keith franchise (actually used only 1914-1916), and elected to report the gain on the installment basis. In determining the value of the assets acquired in 1913 (their basis), the court accepts the par of the stock (the directors' valuation, prior to income tax), and largely on the testimony of a surviving promoter assigns $25,000 to the franchise. Accordingly, $50,000 less the depreciation on the building plans was allowed as an addition to the basis of the theater building in computing gain from the sale. *Burrough Operating Corp.,* TCM 1956-192.

Stock of controlled corporation but not loans worthless in year of liquidation. Taxpayer advanced money to a wholesale grocery company whose stock he owned to provide it with needed working capital subsequent to incorporation and prior to a decision to liquidate it. These, the court holds, were loans rather than contributions to capital. The fact that taxpayer was for all purposes a sole stockholder or that the advances were on open account was deemed not controlling. The court went on to find that the loans did not become worthless in the taxable year since the Company was still in the process of liquidation, the wholesale market was strong, and fast selling items were still being purchased in order to reduce the loss. The capital stock however did become worthless that year. Liquidation was under way and it was clear that all of the creditors could not be paid in full. *Dorminey,* 26 TC No. 118.

Oil royalty interest worthless when well is abandoned. In 1949 taxpayer bought royalty interests in an area near a dry hole abandoned by Sinclair Oil, after he learned that that company planned to deepen the hole. It was deepened late in 1949, and although some oil was found, the well failed to attain commercial production and was finally plugged and abandoned in February 1951. The court concludes that the plugging and abandonment of Sinclair's well was the event that finally demonstrated the improbability of the existence of oil in commercial quantities in the royalty area. The royalties were properly claimed as worthless in that year. *Finston,* TCM 1956-202.

TAXATION OF

Partnerships

EDITED BY ROBERT M. MUSSELMAN, LL.B., CPA

Tax problems of co-owners electing to be treated as a partnership under the new rules

by **WAYMON G. PEAVY**

Co-owners of property have open to them some very interesting tax-planning opportunities as a result of the new rules under which they can be taxed as a partnership. There are problems, as well. This discussion takes the common situation of co-owners in an oil property to illustrate how these problems arise and what to do about them. These same points are applicable to co-ownerships generally.

While the 1954 Code defines partnerships in substantially the same manner as the 1939 Code,[1] the 1954 Code,[2] by implication, and the Regulations[3] expressly, includes co-ownerships among those business relationships which are to be treated as partnerships for tax purposes. As a result, once any business activities are commenced, the seemingly independent co-owners find themselves cast as partners, for tax purposes. Mere co-ownership of property, or a joint undertaking merely to share expenses, would escape because no business operation is being "carried on."

Electing exclusion

The very section which subjects joint operations to treatment as partnerships grants to qualified co-ownerships the privilege of electing not to be treated as partnerships.[4] Before the consequences of the election can be considered, however, it is first necessary to determine those prerequisites which a joint operation must possess in order to be entitled to the election.

Section 761(a) of the 1954 Code provides that at the election of all of its members, an unincorporated organization may be exempted from the application of part or all of the partnership provisions, provided such organization is availed of either for investment purposes or for the joint production, extraction, or use of property, and provided further that the income of the members may be determined without computation of partnership income.

As far as joint operations are concerned, the new partnership Regulations[5] further define these prerequisites by providing that: (1) the members must retain ownership of the property in themselves as co-owners, in fee or under a contract or lease granting exclusive operating rights; (2) each member, as co-owner, must reserve the right to take or dispose of his share of production in kind; (3) the co-owners must not jointly sell the property produced or extracted, although a member may delegate authority to sell his share of production for a period not in excess of the minimum needs of the industry and in no event for more than one year; and (4) the organization must not have as one of its principal purposes cycling, manufacturing, or processing operations for nonmembers.

The *final* Regulations under Subchapter K, as modified by T.D. 6198, are quite different from the proposed Regulations insofar as the election is concerned. Under the final Regulations, there is no distinction between pre-1956 and post-1955 agreements as there was in the proposed Regulations. Instead, in the case of every joint operation, regardless of when formed, the election not to be subject to the provisions of Subchapter K must be made in a partnership return. Such return, in lieu of the usual information, need show only the name and address of the organization and must contain a statement showing the names and addresses of all the co-owners; the sections under which it qualifies for the election; a statement that all members elect to be excluded; and a statement indicating where information about the agreement can be secured. If the election is validly made, no further partnership returns are required, but the organization is required to file, annually, Form 1099 in respect of each person who was a member of the organization for any part of a calendar year.[6] However, in lieu of reporting the "kind and amount of income paid," the form need only show that it is filed under Section 761(a) and state the principal activity of the organization. For the taxable year for which a qualified partnership return is filed Forms 1099 are not required.

Time for filing

Under the Regulations as interpreted by Technical Information Release 19, September 25, 1956, the first partnership return of an organization qualified to elect exclusion is due for the first taxable year in which expenditures are made which are treated as deductions and which are not merely for acquisition or retention of title or for deciding whether to acquire or retain title, regardless of whether the operating agreement is oral or written. Thus, payment of delay rentals or of exploration expenses (other than for locating a well site) would not require the filing of a return. Partnership returns for 1955 were to have been filed on or before October 15, 1956. If no annual accounting period has been adopted for the venture, its taxable year will be the calendar year. The return is to be filed in the district where the joint operation has its principal office or place of business. Usually the operator will file the return, and his principal office or place of business is considered the principal office or place of business of the organization. If a person other than the operator files the return, the principal office or place of business of such person is considered the principal office or place of business of the joint operation.

The election to be excluded from all the provisions of Subchapter K, which is irrevocable except with permission of the Commissioner, will be effective automatically unless one of the members within 90 days after formation of the organization (or by October 15, 1956,

whichever is later) notifies the Commissioner that he desires Subchapter K to apply and also advises the Commissioner that he has so notified all other members by registered or certified mail. A joint operation will be considered as a partnership for tax purposes for every taxable year until an election is made to be excluded from the partnership rules of Subchapter K. The members may exercise their election to be excluded from Subchapter K in the first partnership return or in any subsequent return. Before any such election is exercised, consideration should be given to the possibility of adverse tax consequences thereof, as the election may be considered a termination or liquidation of the partnership.

The Regulations do not discuss the effect of a transfer of an interest in a joint operation. It would seem reasonable to assume that where the new owner is considered an assignee, then he would be bound by the election of his assignor. This rule would not necessarily apply where the transfer of an interest is such that a new joint operation was established by the transfer.

It is possible to elect to be excluded from only certain sections of Subchapter K, but such election is effective only to the extent approved by the Commissioner. The election in this case must be filed wihin 90 days after the beginning of the first taxable year for which partial exclusion is desired.[7] Thereafter, such organization is required to file annual partnership returns containing such information as the Commissioner may require upon the granting of the partial exclusion.[8]

ADVANTAGES

Allocating partnership income, expense

Perhaps the most far-reaching of the new partnership provisions is the section which permits partners to determine by their own agreement how various items of gain or loss are to be allocated.[9] Thus, while co-owners who have elected to be excluded from the partnership provisions will continue to account for only the income and expense allocable to their undivided interests, those who are subject to the partnership rules are in a position to make almost any allocation of the venture's income and expense they desire. The only apparent restriction on this new freedom is the requirement that the principal purpose of any allocation may not be the avoidance or evasion of Federal income taxes.[10] The Committee Report indicates that the allocation must have substantial economic effect and not be merely a device for minimizing taxes.[11] The Regulations are more restrictive: They provide[12] that substantial economic effect is only one factor to be considered in determining whether the principal purpose of any allocation agreement is evasion or avoidance of tax, and that all surrounding facts and circumstances must be considered. Eventually, litigation may be required to define the area between the broad rule of "tax avoidance" and the restrictive "all surrounding facts . . . including substantial economic effect."

Benefits of allocation agreements

The benefits in tax planning that may be derived from specific allocation agreements are manifest. An example that is most intriguing to the oil industry involves the allocation of intangibles. Often, capital for exploration ventures is provided by high-bracket taxpayers who desire the complete deduction for intangible development costs, yet who receive only a fraction of the working interest. If such a program were carried on within the framework of joint operations not subject to the partnership rules, that portion of the intangibles applicable to the operating rights held by others must, of course, be capitalized as leasehold costs. Prior to the enactment of the new Code provisions relating to partnerships, various means were employed to give the investor the full deduction for the costs which he paid, but each of these plans changed the basic economics of the transaction to a greater or lesser extent.

Under the carried-interest arrangement, for example, the entire working interest would be assigned to the participants bearing the costs of acquisition and exploration, usually until such time as sufficient income was received from production of the oil to enable it to pay exploration, development and operating costs after which a specified fraction of the working interest would revert to the carried participants. This method however changed the economics of the original situation.

Another method designed to put the entire working interest in the hands of the parties contributing the risk capital involves use of a net profits interest. Under this arrangement, the party who is to be given the free wells is assigned an interest in the net profits, which is customarily defined as the gross proceeds from production less specified exploration, development and operating costs. Economically, a net profits interest is not identical with the "free well" interest or the carried interest, as the owner of a net profits interest loses some depletion as compared with the owner of a working interest.

Overriding royalty interest

On occasion, an overriding royalty interest has been used as an equalizer; however, since future development and operating costs are not susceptible of precise measurement, it is virtually impossible to determine the size of the override with any degree of accuracy. Various combinations of these interests, together with the use of options and counteroptions, have been attempted at one time or another.

It is now the contention of many tax practitioners that the ability to allocate specific items of income and expense within the partnership framework provides a satisfactory solution to this problem of allocation of intangibles. The partnership agreement, it is argued, could provide that all development costs be allocated among those partners contributing the cash capital. Likewise, the party contributing funds for the depreciable and depletable property could be allowed a special allocation of the items of depreciation and depletion until such time as their investment therein is recovered. Production income and other items of expense could be shared in proportion to the respective interests of the various partners. Such allocations *appear* to have substantial economic effect. Without the cash advances, the exploration expenditures could not have been incurred nor the property acquired; hence, the one who makes the funds available should be allowed the deduction.

The right to specific allocation of intangibles, however, is not entirely free from doubt. The Regulations provide specifically that intangible drilling and

[1] Section 761(a) and §7701(a)(2); 1939 I.R.C. §797(a)(2).
[2] Section 761(a).
[3] Section 1.761-1(a)(2).
[4] Section 761(a).
[5] Section 1.761-1(a)(2)(iii).
[6] Section 1.761-1(a)(2)(v)(a)(2).
[7] Regs., §1.761-1(a)(2)(iv)(b).
[8] Regs., §1.761-1(a)(2)(v)(b).
[9] Section 704(a).
[10] Section 704(b)(2).
[11] Sen. Rep. 1622, 83d Cong., 2d Sess., p. 379.
[12] Sec. 1.704-1(b)(2).

development costs, among other items, must be *separately* accounted for by the partner as though he had realized or incurred them directly.[13] Since each partner's distributive share of intangible drilling and development costs must be separately stated and reported, the taxpayer may find himself confronted with the very limitations he is trying to avoid. Intangible development costs are currently deductible under the provisions of Section 263(c) which specifically recognizes the prior Regulations relating to deduction of intangibles. The Regulations limited the right to deduct intangibles to the taxpayer's share of the working interest. Since the Regulations applicable to Section 263 have yet to be promulgated, a possible conflict between that section and Section 704 may create uncertainty for some time to come. It would appear, however, that specific allocation of intangibles under Section 704 should be permitted.

Specific allocations within the partnership framework may be even more useful as a device in tax planning because of the fact that the partnership agreement providing for such allocations may be modified, for any taxable year, at any time prior to the due date for filing the partnership return. This provision,[14] in effect, permits partners to modify their agreement retroactively at any time within three and a half months after the close of any taxable year, which should provide sufficient time to ascertain the actual results for such year. Incidentally, it has been suggested that this provision makes a partnership return filed on or before the normal due date conclusive evidence as to the intention of the partners operating under an oral agreement or under a written agreement which does not cover allocation of certain income or expense items.[15]

While it is as yet difficult to determine how the purpose or intent test imposed by the code will be applied to specific allocations, it appears that certain general rules might be laid down: (1) a special allocation that is used consistently year after year is more likely to be upheld; (2) allocations made in advance rather than at the end of a taxable year will be less suspect; (3) the fact that related items of income and deduction from the same source are allocated in the same manner is evidence of a purpose other than tax avoidance; (4) a special allocation will probably not stand up if the net cash results to each partner are substantially the same as under the general profit and loss sharing ratio.

Choice of taxable year

Another apparent advantage to the use of partnerships rather than excluded co-ownerships in tax planning is the possibility of securing a fiscal year for the venture which differs from the taxable year of some of the partners. By selecting a partnership year which ends early in the taxable year of those partners desiring this advantage, such partners are able to postpone payment of taxes on partnership income until the close of their taxable year. This obviously provides time to take steps to minimize the tax liability on the partnership income, as for example, by incurring the appropriate amount of intangible development costs in their personal activities.

This freedom in choice of taxable years is not unrestricted, however, since under the 1954 Code a partnership may not change to or adopt a taxable year which is different from that of all of its principal partners without prior approval,[16] nor may a partner change, if he has not received prior approval, to a taxable year different from that of any partnership in which he is a principal partner.[17] Where the principal partners have *different* taxable years, the Regulations permit adoption of a calendar year by the partnership without prior approval.[18] Thus, the opportunity would be available to a partner who is on a fiscal-year basis for tax purposes, providing he can obtain as a co-partner a taxpayer who has a different taxable year and, providing further, such other taxpayer buys at least a 5% interest in capital or profits.

Partnership elections

There is another advantage that may be derived through the use of a partnership in a limited number of cases. The 1954 Code continues the rule that most elections including the election to capitalize or expense intangibles are to be made by the partnership.[19] In the event a taxpayer has in his own capacity exercised the election to deduct or capitalize intangible development costs in a manner which he now finds unfavorable, he may be able to conduct his future operations in the form of a co-ownership subject to partnership rules and thus avail himself of a new election. An *excluded* co-ownership does not qualify as an entity entitled to make elections; therefore, the co-owners are bound by their prior elections which are held to be irrevocable.[20]

DISADVANTAGES

We have seen that joint operations of oil and gas properties may sometimes be conducted advantageously as tax partnerships for several reasons. It remains to inquire into the possible tax disadvantages which may result from operation as a tax partnership.

Termination of partnerships

Before a joint operation elects to be treated as a partnership and adopts a taxable year different from that of any of its members, consideration should be given to the possible bunching of income which may arise when the partnership terminates. To illustrate the problems, let us assume that A, B, and C are equal co-owners of a lease. A has a taxable year which ends September 30, and B and C each have taxable years which end December 31. They do not elect to be excluded from the partnership provisions of the Code and, as permitted by the Regulations, their "partnership" adopts a calendar year. If in a subsequent year the partnership should terminate as of August 31, the partnership year will close and A will have 20 months of partnership income to report in his individual return. The same result would follow if A's interest were liquidated or sold without terminating the partnership.[22] The additional eight months of partnership income would be taxed at A's highest surtax rates and might result in a substantial increase in tax liability.

It is interesting to note that the rules regarding termination of a partnership under local law do not govern in determining when the existence of a partnership ceases for tax purposes. Instead, the Code prescribes with exactness those circumstances which will be treated as a termination of a partnership.[23] First, cessation of partnership activities, which can arise either from a complete discontinuance of the business or from carrying on the enterprise in another form would constitute a termination. For example, if the co-owned property were plugged and abandoned, or if the property were transferred to a corporation, or if one co-owner bought out all the other co-owners so that the continuing operation

was a sole proprietorship, the "partnership" would be terminated for tax purposes. Second, the sale or exchange within any 12-month period of at least 50% of the total interest in partnership capital and profits effects a termination. Third, with one exception, a merger or consolidation of two or more partnerships will result in the termination of all of the merged or consolidated partnerships. Fourth, upon the division of a partnership into two or more partnerships, the old partnership will be terminated unless some of its partners who in the aggregate owned more than 50% of the original partnership continue in a partnership. In this event, the new partnership will be deemed a continuation of the original partnership.

The problems of continuation and termination of partnerships are of particular interest in the oil industry in connection with unitization and pooling agreements. Generally, upon unitization, a participant is viewed as having exchanged all of his interest in his property for an undivided interest in the unit, resulting in an exchange of property interests of a like kind.[24] Under these circumstances, gain is recognized only to the extent of any boot received;[25] loss from such exchange is not recognized.[26]

Assume that A and B are equal owners of a lease and that they elect to be subject to all of the partnership provisions. If the lease is unitized, does the unitization automatically terminate the partnership year with the attendant disadvantage of bunching of income? It appears that unitization should be viewed as an exchange by the partnership of its interest in the lease for an undivided interest in the unit. If the unit does not elect to be excluded from the partnership provisions of the Code, (as a practical matter it is likely to decide to elect the exclusion treatment) and our original co-owners, A and B, own more than a 50% interest in the unit, the new partnership "unit" should be viewed as a continuation of AB. Any other merged partnerships would be deemed terminated. Under these circumstances, the taxable year of AB would not terminate but would continue to be the taxable year of the new partnership. If all of the members of the unit elect to be excluded from the partnership provisions of the new Code or if A and B own less than a 50% interest in the unit, I believe the transaction should be construed as a termination of AB and a distribution of partnership assets.

Contribution of services for an interest

It has long been accepted that a participant may make a contribution of services toward the acquisition and development of oil properties and receive in exchange therefor an interest in the property acquired or developed without being taxed upon the receipt of such interest.[27] This principle, known in industry circles as a sharing arrangement, views the contributor as having contributed his services to the pool of capital represented by the property developed, and his interest has not been regarded as compensation received for services, but rather as representing the enhancement of the property through his contribution.[28] That this theory has been generally accepted is attested to by a series of court decisions and published rulings.[29] The 1954 Code contains no provision which expressly negatives this rule. However, the Regulations[30] provide that the value of an interest in partnership capital, as distinguished from a share in partnership profits, which is given up by any partner and transferred to another partner as compensation for services, constitutes income to the recipient partner under Section 61. In substance, an interest in partnership capital is given up if the transferor partner gives up any part of his right to be repaid the value of his contributions to the partnership, measured at the date the property was contributed to the partnership. The amount of the income received by the transferee partner is the fair market value of the capital interest received, and is taxable at such time as there are no substantial restrictions on his right to withdraw or dispose of his interest.[31] The effect of this provision on sharing arrangements is somewhat uncertain, particularly since the assignor in a sharing arrangement is not deemed to have given up anything but instead is viewed as having an interest with the same relative value in an enlarged pool of capital.

Since under the broad provisions of Section 761, all sharing arrangements in which the participant contributing services receives an operating interest fall under the partnership rules, it would seem that the consequences resulting from this Regulation could be avoided by electing to be excluded from the partnership rules. In the event the parties are willing to vary the economics of the situation somewhat, it appears that the unfavorable results could be avoided by granting the contributor of services a nonoperating interest, such as an oil payment, a royalty or overriding royalty, or a net profits interest. The owner of a nonoperating interest would not be a partner under the 1954 Code because the term partnership implies the carrying on of a business or venture and the owner of a nonoperating interest does not take part in such activity. In the alternative, the partnership agreement could provide that the partners contributing property are first entitled to recover the value of their property contributions before the partners contributing services acquire their interest in partnership capital.[32]

Negative basis property

An exception to the general rule that no gain or loss is recognized by contributing partners upon the contribution of property in exchange for a partnership interest[33] relates to the contribution of negative basis property. This may be defined as property encumbered by a debt in excess of its adjusted tax basis. Where such properties are contributed to a partnership, the contributing partner realizes income to the extent that the reduction in the share of liabilities of the contributing partner exceeds his basis in the property.[34] Since negative basis properties are common in the oil and gas industry, because of percentage depletion and the option to expense intangibles, this exception may have a profound effect upon use of the partnership form of organization. The problem can best be illustrated by the following example. Assume X, Y, and Z decide

[13] Section 1.702-1(a)(8)(i).
[14] Section 761(c).
[15] See Regs., §1.704-1(b)(1).
[16] Section 706(b)(1).
[17] Section 706(b)(2).
[18] Section 1.706-1(b)(1)(ii).
[19] Section 703(b).
[20] Reg. 111, §29.23(m)-16(b)(4); see also Reg. 118, §39.23(m)-16(d).
[22] Section 706(c)(2).
[23] Section 708(b).
[24] Section 1031(a); see also Reg. 118, §39.112(b)(1)-1.
[25] Section 1031(b).
[26] Section 1031(c).
[27] GCM 22730, 1941-1 CB 214.
[28] See also *Farris v. Comm'r*, 222 F.2d 320 (10th Cir. 1955), *rev'g* 22 TC 104 (1954).
[29] See *Taxation of Oil and Gas Income* by Breeding and Burton, Prentice-Hall, Inc. 1954, ¶7.01 *et seq.*
[30] Section 1.721-1(b)(1).
[31] *Ibid.*
[32] See Rev. Rul. 54-84, 1954-1 CB 284.
[33] Section 721.

to pool their resources and develop an oil property. X contributes a partially-developed property worth $20,000, subject to a mortgage of $9,000, in which, because of his election to deduct intangibles, he has a tax basis of $1,000. Y and Z each contribute $11,000 in cash to complete development of the property. If X, Y and Z, who are equal owners, organize their venture as a partnership, by operation of the new partnership liability rules, X's share of the liability will be reduced to $3,000 (⅓ of $9,000), regardless of whether the partnership assumes the liability or merely takes the property subject to the mortgage. The difference of $6,000 is treated as a distribution of money to X, $1,000 of which is deemed a recovery of basis and the balance is treated as capital gains.

Limitation on deduction of losses

Another set of provisions found in Subchapter K, to which oil and gas ventures may be vulnerable, relates to the limitation on deduction of partnership losses. In substance, the deductibility of a partner's distributive share of partnership losses is limited to the amount of his adjusted basis in his partnership interest.[35] In this connection, it should be noted that the basis of a partnership interest is increased as the partner's proportionate share of partnership liability increases.[36] This rule permits a partner to deduct expenses, such as intangible development costs, paid for by borrowed funds.

To illustrate the various problems that flow from these Code provisions, let us assume that A contributes a proved but undeveloped lease with a tax basis of $1,000 and a value of $50,000 to a partnership, AB, in which he has a 50% interest. A's basis in the lease, $1,000, becomes his basis in the partnership.[38] Immediately thereafter, the partnership borrows $50,000 which it spends for intangible development costs. It elects to deduct such costs.[39] Assuming no other transactions during the partnership year, the partnership has a net loss of $50,000, of which A's distributive share would be $25,000. Since A's basis is increased to $26,000, by 50% of the amount of the loan, he would be permitted to deduct his entire share of the loss. If however, the development program had been financed out of B's capital contribution instead of by borrowed funds, A would be entitled to deduct only $1,000 of his share of the loss, since that would have been the extent of his basis in the partnership. The remaining $24,000 would be deducted by A in any future year to the extent that he acquires additional basis in the partnership.[40] This increase in basis may be accomplished by additional contributions,[41] by an increase in partnership liabilities, or by taxable or tax-exempt partnership income including percentage depletion in excess of cost.[43] The nondeductible loss, incidentally, may be carried forward for an unlimited number of years.[44]

The sections of Subchapter K relating to partners and partnership liabilities also provide that the basis of a partnership interest is reduced to the extent of the partner's share of a reduction in partnership liabilities, or by a reduction in the partner's liabilities by reason of assumption of his debt by the partnership.[45] This reduction is treated as a distribution of cash by the partnership to the partner,[46] and to the extent that such distribution exceeds the partner's basis in his partnership interest the excess is subject to tax, generally as a capital gain.[47] The problem resulting from a contribution of a negative basis property, discussed above, is an extension of this provision.

The flexibility afforded by these provisions may make a partnership a useful instrument in tax planning. Assuming sufficient business purpose to justify the transaction, it is possible, where a partnership has liabilities, to select the time for deduction of losses by judiciously increasing or decreasing partnership liabilities. A co-ownership which has elected to be excluded from the partnership provisions does not provide the same opportunity for selecting the time for deduction of losses, since in an excluded co-ownership, the deductibility of a co-owner's loss is not limited to his basis in the property.

Conclusions

In conclusion let me stress that a most vital consideration in tax planning is to make sure that the desired status is attained: the importance of a correct classification of a venture from its very inception cannot be overemphasized. The relative advantages and disadvantages of partnerships as compared to excluded co-ownerships may be of small moment when compared to the adverse consequences that can result to co-owners because an election was defective or because the election was not available for failure to comply with all of the prerequisites discussed earlier. For example, the deduction for intangible development costs may be lost because the partnership did not make a timely election to expense them. In addition, all tax planning may be completely upset because of a shifting of income and deductions between years, in the event the partnership has a taxable year different from that of the co-owners. As a precaution against the loss of intangibles, I would suggest that the qualified partnership return, which must be filed by all excluded co-ownerships, contain a statement to the effect that if the joint operation should be treated as a partnership, the partnership elects to deduct intangible development costs. ☆

[34] Section 752(b); Regs., Sec. 1.752-1(b) and (c).
[35] Section 704(d).
[36] Sections 752(a) and 722.
[38] Section 722.
[39] Section 263(c) and Reg. 118, §39.23(m)-16.
[40] Section 704(d).
[41] Section 722.
[42] Sections 752(a) and 722.
[43] Section 705(a)(1).
[44] Section 704(d); Regs., §1.704-1(d)(1).
[45] Sections 752(b) and 733(1).
[46] Section 752(b).
[47] Section 731(a)(1).

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NEW DEVELOPMENTS IN

Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

To cooperate or not to cooperate in fraud investigation: 14 rules

ONCE AN INVESTIGATION has started and it appears that fraud may be an issue, not until the investigators have prepared their final report is it certain whether criminal prosecution will be recommended by them; the tax adviser cannot intelligently guide his client through this difficult period unless he understands the basic rules.

It must be clear by now that the fundamental problem which pervades all others and around which all of our discussion concerning the correlative rights of the government and the taxpayer revolves is that of determining to what extent, if any at all, should the taxpayer "cooperate" with the agents conducting this investigation. It is unfortunate for the taxpayer and his adviser that the decision must be made, and perhaps irrevocably, at a stage of the investigation so early that in most instances neither the taxpayer nor his adviser has had the opportunity to appraise fully the entire situation and to calculate the eventual risks involved in adopting one course or the other. In a real sense, the adviser is called upon to telescope within a short span of time the taxpayer's entire case, with all its legal and factual ramifications. Bypassing the crux of the dilemma itself—what is meant by "cooperating,"—when should the taxpayer be advised to "cooperate" and forego his constitutional rights, and when should he be advised not to "cooperate" but to rely on his constitutional rights—nevertheless, we are able to make some observations of which the adviser ought to be ever mindful as an aid in reaching his decisions.

The fourteen rules

Rule No. 1. Do not underestimate the intelligence, experience, and integrity of the opposition.

Rule No. 2. Find out the exact administrative position and duties of the agent making the investigation.

Rule No. 3. There is time to make a decision as to cooperation; don't rush in where experts fear to tread. Usually time is not of the essence. The adviser may take a reasonable time within which intensively to check the facts and the law. The investigators will exert constant pressure on the taxpayer and his adviser for information on this or that subject; but if the adviser courteously but firmly informs them that he needs additional time within which to do his own investigating of the case (the government has usually had at least a year's start on him) before he can reach a decision as to whether to comply with their request, no unfavorable reaction will result.

Rule No. 4. Decision on cooperation must be held up until adviser intensively studies the situation.

Rule No. 5. Cooperation is not an "all or nothing" matter. It may be total or limited. For example, much data can be supplied to the investigating agent which will save him time and which does not harm your client's case even if you have not had time to fully evaluate every facet thereof. On the other hand, to give the investigating agent the client's sworn statement is a reckless thing to do unless this step has been thoroughly evaluated.

Rule No. 6. It is usually safe to cooperate to the extent of supplying the data which the agents are sure to find in any event.

Rule No. 7. If crucial data has already been given to the investigators before the adviser is called in to make a decision as to cooperation, a program of non-cooperation loses its appeal.

Rule No. 8. It must be remembered, however, that if the decision is to cooperate, then what is done and what is said as part of that program cannot at a later time be called back.

Rule No. 9. If the decision is to cooperate it must be recognized that whatever is done or said as a part of that program may at a later time prove to be extremely damaging. For example, anything that the taxpayer or his adviser says to the investigating agent will later be repeated and take the form of an admission as to facts without which the government may find it difficult to convict. Also, if an amended return is filed and the deficiencies are paid up in an effort to cooperate, this fact at a later tax-evasion trial may plague the taxpayer.

Rule No. 10. It must be remembered that a program of cooperation on the theory that by doing so the taxpayer is making a "voluntary disclosure" will avail him nothing at this time.

Rule No. 11. If a program of cooperation is adopted on the theory that the taxpayer has a good defense against a possible criminal case, then whatever "leads" the taxpayer has in mind which would aid him must be given to the investigators for them to run down, or the failure of the investigator so to do will avail the taxpayer nothing in a subsequent evasion trial.

Rule No. 12. Where the threat of criminal action is serious in the light of the adviser's evaluation of potential facts, indicating the presence of the type of case where criminal charges usually would be brought, cooperation should not extend beyond offering data which agents could find in any event.

It is increasingly clear, particularly where the flood dam against the use of net-worth cases has been opened by the recent Supreme Court decisions, that it is extremely dangerous for a taxpayer or his adviser, wittingly or unwittingly, to supply information to the investigators during the investigation where criminal charges are a serious threat. Any scrap of information which to the taxpayer and his adviser may seem harmless may later turn out to be an important link in the government's chain of evidence, particularly in net-worth and expenditure cases.

Rule No. 13. It must be remembered that if the decision is not to cooperate this fact itself may be part of the government's proof on the issue of wilfulness in a subsequent evasion trial. While this statement would seem to be shocking in the light of the fact that the taxpayer has a constitutional right to refuse

to incriminate himself, the law seems to be developing to the extent stated in the above rule and the taxpayer and his adviser must take this calculated risk in making the decision not to cooperate with the Service.

Rule No. 14. Possibly the most important rule is to keep in mind proper "timing" as to any steps which may be taken during the investigation vis-a-vis cooperation with the investigators.

What may be a reckless act at one stage of the investigation may become sound at a later stage, depending upon developments. For example, while giving a sworn statement capping the investigation may be good strategy after the adviser fully understands the case and has his defense well in mind, the same step may be most damaging if taken at the very beginning of the investigation. ☆

NEW DECISIONS IN FRAUD & NEGLIGENCE THIS MONTH

Tax Court affirmed in imposing fraud penalties in net-worth case. In this net-worth case, taxpayer's income, fraud penalties and statute of limitations were at issue. This court holds that the Tax Court's findings rested upon its judgment as to the credibility of taxpayer and his witnesses. It therefore will neither reassess the value of the testimony it has not heard nor will it weight the evidence. The Tax Court's decision in the Commissioner's favor is affirmed. *Friedman,* CA-6, 6/27/56.

Consolidated-family net-worth method upheld in fraud case. The Tax Court sustained deficiencies and fraud penalties exceeding $2,000,000 against taxpayer, a one-time convict who had engaged in numerous illicit and gambling businesses. His taxable income was determined by using a consolidated-family net worth and by subtracting therefrom the income reported by the other family members. The court accepted this determination in view of the unusual complexities involved. Lias refused to furnish a net-worth statement, and the Government agents found it difficult to establish ownership of family assets in the absence of books and records. This court affirms. *Lias,* CA-4, 8/3/56.

Farmer's deliberate omissions fraudulent; hiring accountant does not excuse failure to file estimated tax. The Commissioner's determination of the income of taxpayer, a farmer and potato processor, by use of the net-worth method is upheld in spite of taxpayer's contention that the figures should have been adjusted downward for outstanding checks at the close of the year, inventories, equipment, depreciation, and certain amounts designated as living expenses. The court finds a deliberate omission of income and sustains the fraud penalty. It holds that the hiring of an accountant to prepare the tax return did not constitute "reasonable cause" for failure to file a declaration of estimated tax so as to avoid the failure-to-file penalty; there was no evidence that the accountant was engaged to file such a declaration. *Clark,* TCM 1956-176.

Bank deposits used to determine income of betting broker. Taxpayer, betting broker or go-between who took bets from various bettors, kept no books or system for keeping records of his income. The court upholds use of the bank-deposit method to determine his income and allows the taxpayer, by application of the *Cohan* rule, 75% of the total deposits and undeposited checks for transfer items or payments. As taxpayer omitted more than 25% of his gross income for 1949, the three-year statute of limitations did not bar the assessment for that year. *Rogers,* TCM 1956-171.

Net-worth computation upheld; claim of cash unsubstantiated. Taxpayer filed no income tax returns for 1944 to 1950. By the net-worth method, the Government determined taxpayer's income. Taxpayer claimed he had $70,000 in a safe deposit box on January 1, 1943, but he introduced no evidence to substantiate his testimony. The court approves the opening net-worth computation. *Veino,* DC Fla., 7/17/56.

Restaurant owner's income determined by net worth. Use of the net-worth method was ruled proper in determining the income of a restaurant owner with inadequate records who received 25% of the net proceeds from a gambling concession on his premises. *Lopez,* TCM 1956-203.

Gambler's income reconstructed from net worth. The Commissioner is held justified in resorting to the net-worth method in computing taxpayer's income. The books and records of his solely owned corporation which operated a photographic studio were inadequately kept, and he maintained no records whatsoever of his extensive gambling activities. The substantial omissions, extensive gambling activities, lack of records, and general character of the taxpayer, as shown by his demeanor on the witness stand, convince the court that the returns were false and fraudulent with intent to evade tax. *Tarr,* TCM 1956-194.

Jury acquits of fraud in reported checks; defendant said he cashed them. Defendant reported a loss in 1948, but the Government asserted that he received some $11,000 of checks which represented unreported income. Taxpayer did not dispute the checks but said that he merely cashed them for participants in various gambling games. The jury acquitted him of the criminal-fraud charges. *Gibson,* DC Colo., 4/27/56.

Failure to file returns fraudulent. An auto salesman filed no returns for 1946 and 1947, although he received substantial sums in salaries and commissions in these years. He also retained 25% of the amounts received on sales of autos which exceeded the invoice price. The failure to file returns is held to be due to willful neglect and to evidence a fraudulent purpose. *Richards,* TCM 1956-168.

Fraud penalty is computed on total EPT without regard to 722 claim. Section 722 relief was denied a corporation in the business of fabricating and selling steel and ornamental iron. The "total deficiency" on which fraud is computed includes the excess profits tax liability deferred under Section 710(a)(5), which provided that claimants of 722 relief need not pay the full tax immediately.

REPRINTS

A few reprints of the four short articles on tax fraud written by Mr. Balter which appear here in September, October, November, and December are available, price, 50¢. Order from: The Journal of Taxation, 147 East 50 St., New York 22.

Calvert Iron Works, Inc., 26 TC No. 97.

Fraud in withholding summaries; evidence voluntarily turned over by officer admissible. The court here sustains the conviction of the president and another corporate officer for fraud in concealing admission taxes collected by the theater corporation. The act of concealing monthly summaries of tax is willful. Records voluntarily turned over to the Government by a corporate officer are proper evidence; there is no self-incrimination. *HJK Theater Corp.*, CA-2, 8/2/56.

Conviction for tax evasion upheld; Government's opening net worth adequate. When taxpayer was convicted of tax evasion in the district court, he raised several points on appeal. He claimed that it was error to admit into evidence the accountant's workpapers. (Whether the accountant was an employee or public practitioner is not clear.) Their admission was held proper as being entries and records made in the regular course of business. They were prepared at the same time stock in defendant's corporation was issued. Taxpayer also contended that the Government failed to establish with reasonable certainty an opening net worth. The court dismissed this objection with the statement that "old mail bags and old iron pots are hardly the explanations reasonably susceptible of being checked." Taxpayer also claimed that competent evidence had not been presented to the indicting grand jury. Referring to the Supreme Court decision in the *Costello* case, the court states that the Fifth Amendment requires nothing more than that the grand jury be legally constituted and unbiased. *Smith*, CA-8, 8/16/56.

Income from black-market operations reconstructed. During 1943 and 1944, taxpayers operated a black-market steel-wool business. They operated on the cash basis, without any records, sales invoices, inventory controls, or books of account. They admitted unreported sales in the amounts of $74,000 and $45,000 during the two-years, but they contended the Commissioner was wrong in determining additional income from commission sales. The court concludes taxpayers in fact received no commissions but did derive an additional $5,500 of income from direct sales. Fraud penalties are sustained. *Brill*, TCM 1956-182.

No proof that house builder received kickback from carpenter. Taxpayer, in the business of building and selling houses, hired a carpenter to construct certain houses at $1 per square foot. After completing three houses, the carpenter notified taxpayer that he could not do the work at the contract price and demanded $1.50 per square foot for the remaining houses. Taxpayer orally agreed, and upon completion of the job and gave the carpenter a check for $6700 representing the increased price. He added the entire amount to his cost. The Commissioner disallowed part, saying the carpenter "kicked back" to taxpayer. After considering all the facts, the court concludes that the carpenter did not return to taxpayer any money from the proceeds of the check but that the check (except for a portion conceded to be an overpayment), represented a bona fide payment for work done which should have been added to the cost basis of the houses. Accordingly no part of the deficiencies was due to fraud with intent to evade taxes. *Robinson*, TCM 1956-193.

Officer's receipt traced to understatement of corporate income. The Commissioner determined that the president and owner of a corporation in the business of manufacturing and selling women's suits and coats made expenditures, deposits and investments in amounts substantially exceeding receipts from all known sources. He treated the excess as understatements of net income by the corporation and distributions of dividends to the officer to the extent of the corporate surplus. The court agrees. The actions of the president, who completed a four-year course in accounting, in charging personal items to corporate purchases and causing them to be reflected as part of the cost of goods sold was held to evidence fraud with intent to evade taxes on the part of both the corporation and the officer. *Hub Cloak & Suit Co.*, TCM 1956-196.

Net worth used to determine income from illegal liquor business. Taxpayer conducted an illicit liquor business almost entirely by cash transactions and with little record-keeping. A reconstruction of income by the net-worth method is held proper. The court finds that understatements of net income in substantial amounts over a period of years is sufficient to sustain the fraud penalty. *Davis*, TCM 1956-206.

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Proposed Regulations do not clarify tax status of "exempt organizations"

by **ANDREW B. YOUNG & CHARLES O. GALVIN**

Taxability of foundations, charities, schools, hospitals, and other so-called exempt institutions brings into play the most difficult element in all taxation: how to assist the good and prevent the bad—all with one set of rules. In attempting to close the doors on tax chiselers, the new Regulations seem to be introducing criteria more subjective than ever. While the following article is pretty critical of the new Regulations, it does, in the course of pointing out where the IRS might have done better, expose for tax men the kind of trouble they can expect in getting and maintaining exemption for such organizations.

PRACTITIONERS HAVE LONG needed definitive rules governing the qualifications for tax exemption of certain organizations. Shadowy, undefined areas existed under the 1939 Code, Regulations 118 and related cases. After the 1954 Code was passed and while practitioners awaited the promulgation of the proposed Regulations, they had reason to hope that the picture would be sharpened, that clear, firm standards would replace subjective criteria.

These Regulations were published on January 21, 1956.[1] They add new material to the old Regulations so that they cover many of the statutory provisions that appeared for the first time. But they do not add anything significant in two new areas of the statute. Although the Code provided relief to certain testamentary trusts from the penalties for unreasonable accumulations, and although it revised the rules affecting business leases, the proposed Regulations merely paraphrase what was previously stated in committee reports on the subject of testamentary trusts and do not even do that much on business leases. In fact, they even omit an example which appeared in the committee reports. The balance of the changes in the proposed Regulations expand definitions of old statutory concepts and sharpen old regulatory concepts.

Difficulties in securing exemptions

Although the provisions of the Regulations, which refer to proof of exemption by exempt organizations were modified somewhat from their counterparts in Regulations 118, they continue to be confusing because they omit essential points. The statement that "an organization which has been granted exemption under the provisions of the Internal Revenue Code of 1939 may rely on that ruling . . ." probably comes as a surprise to the Automobile Club of Michigan. This organization recently experienced a partially-retroactive revocation of its exemption.[2]

Similarly, the statement that "an organization claiming exemption . . . shall file the form of application that is appropriate to its activities" gives no warning that the Service's policy[3] is not to accept applications until 12 months' operations are completed and figures submitted. This inevitable delay, the procrastination by many District Directors for several months before sending the complete file to the national office, and the workload in the Pension and Exempt Organizations Branch have created delays between organization and ruling of from a year and a half to two years. These delays persist even for "conduit" foundations. These cases, which should not present "involved or questionable issues," are supposed to be ruled upon in the district director's office.[4] But all too many of them are passed on to add to the already heavy workload in the national office. Because of these delays, many existing charities have been forced to attempt to secure for themselves donations which they can use for newly-organized affiliates rather than face the delay in getting a ruling letter for the affiliates.

The Regulations advert to the necessity of filing information returns on Form 990-A, but they give no warning of the instruction to the District Director to return to the institutions all forms filed prior to the issuance of an exemption ruling.[5] What is perhaps more serious is that the Service takes the position, with dubious support of law, that an organization is not exempt until it is ruled to be exempt, and that pending such a ruling it must file taxable returns.[6] The only relief it can obtain is by a series of requests for extension or payment followed by a later claim for refund. Although insignificant revenue is involved in this procedure, the Service has shown no inclination to relieve this unjustified burden upon taxpayers.

Because some exempt organizations operate on a strictly "correct" basis until a ruling can be obtained, and then enter into questionable transactions with affiliates or promoters, there is under consideration a proposal that affiliated exempt organizations be required to re-

[1] Vol. 21 Federal Register No. 14—pp. 460-482. All citations preceded by 1. are Sections of the tentative Regulations. All references to Section number are to the 1954 Internal Revenue Code unless the contrary appears in the text.
[2] 230 F.2d 585 (6th Cir. 1956). This is not the only case decided or "on the way up" in which the revocation of an exemption is given retroactive effect. The Service, however, insists that all of these cases present special facts and that it is not departing from its announced policy of honoring its own exemption letters.
[3] Rev. Rul. 54-164, 1954-1 CB 88. This rule does not apply to "well-known religious denominations," "hospitals, orphanages and the like, publicly supported and managed" and "schools and colleges which normally have a regular faculty, curriculum and student body."
[4] Rev. Ruling 54-164 (Sec. 3.01) and Commissioner's Delegation Order No. 17 (1956).
[5] Rev. Rul. 54-164, 1954-1 CB 88.
[6] Rev. Rul. 54-393.
[7] Allied Trade Club, Inc. v. Comm'r, 228 F.2d 906 (3d Cir. 1956) aff'g, 23 TC 1017 (1955) (social and recreational club maintained a modest death benefit fund and lost its exemption); Allgemeine

submit their Form 1023 several years after securing an exemption ruling. If this ruling should be adopted, the reason for the "12-month rule" would disappear.

Effect of secondary activities

The Regulations frequently refer to "principal, primary and predominant purposes" to which "substantially all of its activities" are devoted. This phraseology permits the inference that secondary purposes and insignificant noncharitable activities will be tolerated. Much case law supports this conclusion, but recent cases[7] have underscored the risks of having one organization engage in more than one exempt activity (i.e., these cases emphasize the word "exclusively" used in the Code rather than "predominantly" used in the Regulations). As a result the tendency to organize a separate organization for each exempt purpose persists, despite the soothing remarks in the Regulations to the contrary. If the secondary activity is close to the borderline of exemptability, separation is a must.

Related trustees

The Regulations give no warning that the Service is re-examining its position[8] on trustees or directors who are affiliated with a creator or substantial contributor. Despite the fact that it has long been taken for granted that this affiliation in itself will not prevent exemption,[9] the Service has recently refused to rule on several cases in which the governing board of the organization seeking exemption was affiliated (even more remotely than is covered by the constructive-ownership rules of Section 318) with the individual benefactor or the directors of a substantial corporate contributor. That the Regulations do not state the Government's position on issues of this character is to be regretted. Regulations are not susceptible to clandestine change as is the Service's policy!

Reimbursing the organizer

The mechanics of organizing an exempt organization have been complicated by at least two IRS attitudes, of which no warning is given by the Regulations. An unpublished ruling has suggested that a charity is being operated for the benefit of a private individual-donor if it agrees to pay back to him an amount equal to his cost of appreciated property. In the face of some of the published rulings this comes as a shock.[10] A published ruling has suggested,[11] in the case of an "incorporated hobby," that the exemption of an otherwise exempt organization is in jeopardy if the organization reimburses the organizer for his pre-organization expenditures. Although the Service faces a difficult problem, this type of solution will in the long run only result in raising "form over substance" issues.

New qualifications for exemption

The change in Regulations concerning Section 501(c)(3) organizations results partly from changes in the statute. "Corporations, . . . testing for public safety," have been added, and an additional qualification is prescribed for all Section 501(c)(3) organizations: ". . . and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office." Thus, whereas the old Regulations (39.101(6)-(1)(a) (1), (2), (3)) provided three tests for qualification under Section 101(6) of the 1939 Code, the new Regulations add a fourth test, i.e., nonparticipation in a political campaign.

The old Regulations gave no hint of the Treasury interpretation of the statutory provisions "operating exclusively for religious, etc. . . . purposes." But the proposed Regulations state that the organization will be deemed to be formed and operated exclusively for one or more of the specified purposes if its principal, primary, and predominant purposes, and substantially all of its activities, are devoted to such purposes. The proposed Regulations then state that an activity which is incidental, secondary, or subservient to the organization's exempt purpose or purposes and, which when weighed against the whole is less than a substantial part of the total activities, will not ordinarily operate to deny exemption. This language is so cautious and hedged with qualifiers as to be of little use to the practitioner. The draftsmen might more easily have said "exclusively" means "almost exclusively" and let it go at that. Words like "principal," "primary," "predominant," "incidental," "secondary," "subsequent," "substantial," and "less than substantial" lead almost inevitably to litigation, since they are tests without adequate objective standards.[12]

A portent of things to come is suggested by two recent cases: *Duffy v. Birmingham*[13] and *Ohio Furnace Co.*[14] In the first, a trust was held nonexempt because its expenditures were used only to purchase stock of the widow of the former president of an industrial company. In the second, the court exempted a foundation which engaged in a similar "bailout" by disbursing its funds principally to pay off notes issued to the sellers of stock of a furnace company.

The effect of "secondary activities" has been dramatized in two areas in which the Commissioner seems determined to make new law. In the *Kolkey* cases,[15] a charitable organization was used to purchase going businesses at prices requiring that substantially all the income for many years be applied against the purchase price. The suggestion is made that the organization is not "organized and operated exclusively" for charitable purposes. In another case which is still at the administrative stage, it has been suggested that substantial business-lease income received by an otherwise clearly-exempt, publicly-supported organization deprives the organization of that "exclusiveness" that is necessary to Section 501(c)(3) exemption and Section 170(c)(2)(B) deductibil-

Arbeite Verein, 25 TC No. 47 (1955) (social club and benevolent association activities, which would have been exempt if separate, fail to meet the standard combined).

[8] IT 3220, 1938-2 CB 164.

[9] Sugarman, 14 NYU INST. ON FED. TAXATION 99 (1956); Alexander, 2 ANNUAL NYU CONF. ON CHARITABLE FOUNDATIONS 102 (1955); Casey, ENCYCLOPEDIA OF TAX PROCEDURES 1416 (1956); Sams, ABAJ 278 (March 1956); Montgomery, FEDERAL TAXES 17.53 (36th ed. 1956).

[10] This is not different in substance from a transfer to a charity of appreciated property in exchange for an annuity — which was approved in a letter ruling published at 1956 P-H FED. TAX SERV. ¶76312.

[11] Rev. Rul. 55-610, IRB 1956-41 at 10.

[12] The broadened language of the Regulations recalls the opinion of Mr. Justice Murphy in Better Business Bureau v. U. S., 326 U.S. 279 (1945), in which he stated with respect to comparable language in Section 1426(b)(8) of the 1939 Code (now Section 3121(b)(8)(B)): ". . . an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single noneducational purpose, *if substantial in nature*, will destroy the exemption . . ." (emphasis supplied)

[13] 190 F.2d 738 (8th Cir. 1951).

[14] 25 TC 179 (1955) on appeal to 6th Circuit.

[15] See Ross, *Foundations Established by Individuals*, at 14 NYU INST. ON FED. TAXATION 115, 121-3 (1956). These cases are in litigation in the Tax Court.

[16] The new language in 1.501(c) is: "Thus an activity which is in fact, incidental, secondary or subservient to an organization's exempt purpose or purposes and which when weighed against the whole of the activities of the organization is less than a substantial part of the total, will not ordinarily operate to deny exemption. . . ." It has been suggested that this language implies that where the *quantity* of gross revenues from business leases or unrelated business is large with reference to otherwise nontaxable receipts (even though net revenues are small in comparison with public donations), the organization fails to meet the "exclusively" test. This new position is not based upon 1954 amendments or new case law. No doubt this is another example of hard cases making bad law!

ity![16] The progress of these cases may be watched by tax practitioners with interest.

Public welfare

The "charitable" organization definition is essentially the same as in the old Regulations. In place of "relief of the poor" is "relief of poverty, distress or other conditions of similar public concern." The example of a charity which does not lose its tax-exempt status by receiving contributions from beneficiaries is elaborated upon by another example of a hospital which does not necessarily lose its exemption because it requires payments from those able to pay. This example was suggested perhaps by two decisions in point in which the Commissioner was unsuccessful.[17]

Education

The expanded definition of educational organizations attempts to distinguish between those simon-pure educational organizations embraced in Section 501(c)(3) and the proselytizing, crusading, or evangelistic type embraced in Section 501(c)(4). To the extent, of course, that the questioned educational organizaton qualifies under paragraph (3) rather than (4), there is made available to the donor-contributors an income, as well as an estate or gift tax deduction.

The proposed Regulations stress the importance of objectivity in the presentation of factual data if the organization is to qualify. Espousing a particular cause or taking a particular viewpoint will not necessarily preclude exempt status, provided that the organization presents all the facts which would permit the public "to reach independent and informed conclusions." It would, of course, be helpful if the Regulations contained some examples which would assist the practitioner in formulating opinions about organizations that are in the doubtful area.

Previous cases in point, however, may be reexamined to ascertain whether the proposed Regulations conform to the already-established pattern defining what is educational and what is propaganda. One organization collected and distributed information about the political, social, and economic facts of birth control and attempted to enlist the support of legislators in amending statutes on the subject. It was held not to be educational.[18] A similar organization which abandoned its legislative activities was deemed to be charitable, educational, and scientific.[19] Another organization was organized to promote an intelligent understanding of the movement for a new social order based on industrial production for use and not for profit. Although it promoted debates and discussion about social and economic problems, it "had no legislative program" and was held to be educational.[20] An organization designed to propagate the "single tax" ideas of Henry George was educational,[21] but a local tax club formed to advocate abolition of taxes on industry and a single tax on land was not educational because the group did not present fairly and fully the facts about a disputed question.[22] A league which gathered and disseminated facts about alcoholism on an impartial basis and had no legislative program was deemed educational,[23] although in an earlier case a similar organization was held not to be educational.[24] An association for the promotion of the League of Nations carried on educational activities in the sense that it presented facts fairly about a controversial subject; nevertheless, it was not educational because it also espoused a concerted effort to influence legislation and candidates for public office.[25]

More recent decisions have not abated the confusion. The Tax Court held that the Foundation for World Government was not educational, because its primary goal was to propagandize a movement for world unity.[26] A district court in Illinois, however, found that the Bureau of Jewish Employment Problems, whose goal was to bring about employment without regard to race, religion, or national origin, was educational.[27] The National League of Women Voters has also been the subject of conflicting decisions of the Board of Tax Appeals and, quite recently, of the Tax Court. The Tax Court held that the Cincinnati League of Women Voters was not precluded from carrying on political activities—that its purposes were general in character, and not educational.[28] However, in an earlier decision, it held that the St. Louis League of Women Voters was educational.[29]

Neither the 1939 Code nor the present law contains any criteria for distinguishing "educational" from "social welfare" organizations. Objective standards may be difficult to devise, but this is an area to which some legislative attention should be given.[30]

Lobbying

The proposed Regulations define the proscribed activities; viz., attempts to influence legislation and political activities. Here again, the Regulations state only general principles. The tests become subjective, turning on the facts and circumstances of each case. If an organization, otherwise exempt, publishes books or gives lectures which are incidentally a matter of legislative concern, it does not lose its exempt status; however, if a substantial part of the activities consist of the espousal of but one side of an issue, the exemption will be denied under this section. Similarly, with respect to intervention or participation in a political campaign, a coincidental advocacy of a candidate is permitted, but an active support of a candidate is fatal to exempt status. Mere advocacy of the same principle as a particular candidate may also advocate will not operate to deny exemption unless the advocacy of the principle has the primary purpose of advocating the candidate. Such hairline distinctions present opportunities for excursions into the metaphysical. In an election year in a local community where some burning question is at issue between two candidates for public office, who can say

[17] Goldsby King Memorial Hospital, TC MEM. DEC. DKT. 204 (1944); Davis Hospital, Inc., TC MEM. DEC. DKT. 496 (1945). In Isabel Peters, 21 TC 55 (1953), a foundation which provided public swimming facilities was held to be charitable; see also Arthur Jordan Foundation v. Comm'r, 210 F.2d 885 (7th Cir. 1954), (charitable status upheld where one purpose was fostering "social advancement, including music and the arts").
[18] Slee v. Comm'r, 42 F.2d 184 (2d Cir. 1930), American Birth Control League.
[19] Faulkner v. Comm'r, 112 F.2d 987 (1st Cir. 1940), Birth Control League of Massachusetts.
[20] Weyl v. Comm'r, 48 F.2d 811 (2d Cir. 1931), League for Industrial Democracy.
[21] Leubuscher v. Comm'r, 54 F.2d 998 (2d Cir. 1932), The Robert Schalkenbach Foundation, Inc.
[22] *Idem*, Manhattan Single Tax Club.
[23] Cochran v. Comm'r, 78 F.2d 176 (4th Cir. 1935), World League Against Alcoholism.
[24] Fales, 9 BTA 828 (1927).
[25] Forstall, 29 BTA 428 (1933).
[26] Estate of Blaine, 22 TC 1195 (1954).
[27] Bureau of Jewish Employment Problems v. United States, 000 F. Supp. 000 (ND Ill. October 5, 1955).
[28] Seasongood, 22 TC 671 (1954), *rev'd*, 227 F.2d 907 (6th Cir. 1955).
[29] Smith, 3 TC 696 (1944). The Tax Court emphasized the nonparticipation in legislative activity. Compare also Dahlinger, 20 BTA 176 (1930), holding contributions to the Pennsylvania League of Women Voters deductible, and Noyes, 31 BTA 121 (1934) holding contributions to the Minnesota League of Women Voters nondeductible. See also Liberty National Bank & Trust Co. of Louisville v. United States, 122 F. Supp. 759 (DC Ky. 1954), holding that contributions to League of Women Voters of Louisville are deductible even though the organization did carry on certain work which was an attempt to influence legislation. Martha Hubbard Davis, 22 TC 1091 (1954), *acq.*, 1954-2 CB 4 (social service work among the underprivileged).
[30] See statement by Norman A. Sugarman, Assistant Commissioner of Internal Revenue, before the Special Committee of the House of Representatives to Investigate Foundations and Other Organizations (June 9, 1954). An interscholastic association whose primary purpose is the promo-

that a lecture sponsored by an exempt organization is an "advocacy or espousal of a principle or philosophy or an issue as distinguished from the advocacy of the candidacy of an individual . . ."?

Social welfare

The proposed Regulations expand the definition of civic leagues by emphasizing the "social welfare" aspect of such organizations. Unlike the rules under (c)(3), the Regulations on (c)(4) emphasize that organizations may present opinions or public questions with a view to molding public opinion or getting the public to accept views which may lead to legislation.[31] Of course, contributions to (c)(4) organizations are not charitable deductions. But it may be business expense and deductible.

Business leagues

With respect to business leagues, the proposed Regulations are taken from the previous Regulations. In two recent rulings, the Commissioner has narrowed this exemption. He held taxable those leagues whose activities are the performance of service for members as contrasted with nontaxable leagues whose purpose is improvement of business conditions of members as a whole.[32] This distinction seems unwarranted. The second type of organization will invariably benefit the members or it would not have been organized. The benefit to the individual member will, of course, benefit the industry as a whole, and conversely, the welfare of the industry inures to the members. How shall it be decided which is the primary purpose? The increasing number of these organizations indicates that the problem is becoming of more than academic interest.

Business leagues have recently been confronted with a novel approach to the lobbying problem. In several instances, contributions to business leagues have been disallowed in proportion to the extent that the league engages in lobbying.

"Churches and conventions of churches"

Because of the exemption of churches and associations or conventions of churches from the tax imposed by Section 511, there have been increasing signs of abuse by pseudochurches. In the new Regulations, the Treasury quite properly and legitimately proposes a more specific definition of a church; it ties the definition to the ministration of sacerdotal functions and the conduct of religious worship consonant with the tenets and practices of the particular faith or discipline. The last two sentences of 1.511-2(a)(3)(ii) state that the carrying on of a trade or business for profit through controlled entities may not be tax-exempt. Administrative enforcement of this section should be encouraged to protect legitimate religious groups.[33]

Unrelated activities

The proposed Regulations carry forward from the old Regulations (39.101-2(b)) an example which seems violative of the spirit of both the old law and the new law so far as carrying on an unrelated trade or business is concerned. The example given demonstrates that if three unrelated exempt organizations own in equal shares all the stock of a subsidiary power company which supplies all the power to each of the parent organizations, such subsidiary would not be exempt since with respect to each parent organization the subsidiary is carrying on an unrelated trade or business by supplying power to the other unrelated exempt organizations. One of the recommendations made at the hearings upon the tentative Regulations was that this example be modified so that

tion and direction of high-school athletic programs is an educational organization; Rev. Rul. 55-587, IRB 1955-38, at 11; compare with definition of an "educational institution" in Section 1.151-3(e) of proposed Regulations. See also Estate of Thayer, 24 TC 384 (1955), on appeal to the 9th Circuit, in which California Alumni Association was held to be exempt as an educational organization, the social and recreational activities being considered incidental. But an organization which raises funds to "buy" athletic talent for old alma mater is not educational. Rev. Rul. 56-13, IRB 1956-3 at 14.

An organization incorporated for the purpose of (1) making known to the world the contents of certain books of a designated author who was one of the incorporators of the organization and (2) acquiring property for centers, reading rooms, lecture halls, etc., is not educational. The primary purpose was the purchase and distribution of the books of the author. Rev. Rul. 55-231, 1955-1 CB 72. See generally Chommie, *Federal Income Taxation: Transactions in Aid of Education*, 58 DICK. L. REV. 189 (1954).

[31] See Scofield v. Rio Farms, Inc., 205 F.2d 68 (5th Cir. 1953) followed in Rio Farms, Inc., TCM 1955-306. An organization engaged in promoting sound and economical government is exempt under Section 501(c)(4) and not Section 501(c)(3). Rev. Rul. 55-269, 1955-1 CB 29.

[32] Rev. Rul. 56-65, IRB 1956-10 at 7, states that an organization is not exempt under Section 501(c)(6) if its principal activity consists of furnishing information to and advertising the products of its members who are engaged in the building-engineering-construction business. The Commissioner was of the opinion that the primary purpose was to benefit the individual members and not the improvement of business conditions. *Cf.* Rev. Rul. 54-442, 1954-2 CB 131; Rev. Rul. 55-444, IRB 1955-28 at 7. Rev. Rul. 56-84, IRB 1956-11, at 10, states that an organization operated primarily to handle the national advertising of its members is not exempt since the service is for the benefit of particular members rather than the improvement of business conditions generally.

[33] See Garland and Cahill, *The Concept of Church in the 1954 Revenue Code*, 1 CATHOLIC LAWYER 27 (1955).

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exempt status is not lost if the power consumed by each parent is in proportion to its ownership of the subsidiary power company.

Prohibited transactions

Expanding the discussion in the old Regulations the proposed Regulations place particular emphasis on the first in the enumerated list of prohibited transactions, namely, loans of income or corpus without adequate security and a reasonable rate of interest. Here the explanations and examples become flights of fancy. It is doubtful that the most conservative mortgage banker could conform to or would agree with the rigid requirements there set out. Adequate security is given a definition which is all the Treasury's own. It certainly does not accord with accepted business practice. The requirement that value and liquidity of the security cover principal and interest and the ruling that stock or unsecured debentures of the borrower is not security are unrealistic. Any one of the examples given could be a normal business transaction in the money market. Yet the Regulations dogmatically state that the security in each case is inadequate. If these examples must remain, then their rigidity could be softened by language which would indicate that they are merely suggestive and that in any event the facts and circumstances of each case should control.

In all fairness, it might be observed that the root of the evil is legislative and not administrative. [Some do not agree. See 4 JTAX 341. *Ed.*] It just isn't reasonable to require higher standards of security in the lending of money than in an investment in an equity security. The extreme was demonstrated in the public hearings on the tentative Regulations. Representatives of publicly-held companies cited instances of their pension plans (covered by the same rules of "prohibited transactions") which had invested in high-grade debentures of the employer corporation. These plans now appear to be in jeopardy of loss of exemption by reason of the examples given. The trend of the law on trustees and fiduciaries is toward the "prudent man" standard, what a prudent man would do in the conduct of his own affairs. The general acceptability of this standard may indicate that the whole prohibited-transaction concept was hastily conceived and ill-advised.

DEDUCTION FOR EXPENSES OF ESTATE PLANNING

THE American Bar Association has recommended to Congress that the tax laws be amended to permit a deduction from income taxes by individuals for expenses incurred in estate planning. They would include all legitimate costs in connection with such planning. This change is needed, says ABA, to eliminate controversy and arbitrary action on the part of the Treasury Department.

Unreasonable accumulations

Although provisions relating to unreasonable accumulations have been in the Code since 1950, only four Revenue Rulings on the subject have appeared since that time.[34] The tentative Regulations offer no additional guidance. That this section is being used as a club in "bailout" cases is a matter of public record,[35] although the Tax Court did not adopt the concept in a case decided recently.[36] Just as in Section 531 (formerly Section 102), cases,[37] each case is to be decided on the basis of its own peculiar facts; however, it is to be regretted that the Regulations do not throw further light upon this very shadowy area, and that no warning is given of the Government's hostile attitude in cases where substantially all the income is required for the payment of installments of purchase price. This attitude would penalize a leaseback case by denying exemption generally as well as by taxing business-lease income.

Unrelated business income

Perhaps one of the most difficult questions in the area of unrelated business taxable income is the interpretation of the statutory language "regularly carried on." Both the old (39.422-3(a)(3)) and the proposed Regulations contain identical language. They state that conduct of a business with "sufficient consistency to indicate a continuing purpose" to derive income from such business is "regularly carried on." They also state that an infrequent or seasonal activity may for this purpose be "regularly carried on." Some examples in this connection would have been helpful.

Other difficulties will be encountered in determining "related" and "unrelated," even though examples are given in 1.513-1(a)(4). Moreover, the "convenience" exception of Section 513(a)(2), which is merely restated in the proposed Regulations at 1.513-1(b)(2), may admit of such liberal interpretation by the courts that the intent of the legislation may be defeated. The plight of schools of higher learning who have tried to absorb mounting operating costs out of reduced endowment income has led them into many activities which formerly were contracted for extramurally. Colleges and universities are today big business. Printing and power plants, laundry and dry-cleaning service, food service and catering, canning factories, apartment hotels for married students and faculty, health, and welfare and recreational facilities are all part of the campus operation. One might certainly say without violence to the language that each activity is carried on "primarily for the convenience of its members, students, patients, officers, or employees." It is hoped that appropriate rulings may set at rest any question about the propriety of such activities.

Conclusion

The tentative Regulations represent an honest attempt to clarify the law in many areas that defy precise definition. If any fundamental improvement is to be achieved, legislation is the only solution. Here again the draftsmen's task is not to be envied. As long as churches (alone out of all eleemosynary institutions) are to be permitted to compete with private industries, hearings on the definition of "churches" will continue to be marked more by emotion than by reflection. As long as harried administrators are required by Congress and the courts to draw fine lines between education and proselytizing—between public enlightenment and lobbying—Regulations and rulings will continue to be frustrating. So long as the standard of proper conduct by exempt organizations is to be judged by arbitrary standards of "prohibited transactions" and statutory will-o-the-wisps of "unreasonable accumulations," legitimate charities will continue to flounder in uncertainty. The suspicion persists that a "new deal" is in order. ☆

[34] Rev. Rul. 54-137, 1954-1 CB 280 (conduit organization accumulating one year's income); Rev. Rul. 54-227, 1954-1 CB 291 (restoring past invasion of corpus); Rev. Rul. 54-420, 1954-2 CB 128 (use of income to pay off purchase price); and Rev. Rul. 55-674, IRB 1955-45 (concerning treatment of commitments for future expenditures). For a complete summary of the state of the law, see Mansfield, 14 NYU INST. ON FED. TAXATION 47 (1956).

[35] Rev. Rul. 54-420, 1954-2 CB 128.

[36] Ohio Furnace Company, 25 TC 179 (1955), on appeal to 6th Circuit.

[37] Note the cross-reference to this in the tentative Regulations 1.504-1(c).

NEW DEVELOPMENTS IN

State & local taxation

EDITED BY JOSEPH P. STAPCHINSKAS

State taxation of interstate business under the Commerce Clause

by **JEROME R. HELLERSTEIN**

In the shifting and fluid field of the powers of the States under the interstate Commerce Clause to tax business done across State lines, a knowledge of the background, development and forces affecting current decisions is essential. Mr. Hellerstein, a leading authority and practitioner in this field, traces these developments, considers the current efforts by the States to meet Supreme Court restrictions, and points up newly-emerging doctrines.

THE CONFLICT between the taxing powers and revenue needs of the states and the requirements of a unified national economy is inherent in our Federal system. While Congress has ample power under its constitutional authority to regulate commerce between the states, to determine the extent and mode of state taxation of interstate business, with rare exceptions, that power has not been exercised. The role which Congress has neglected to perform was assumed by the Supreme Court, acting principally under the Interstate Commerce Clause and to a lesser extent under the Due Process of Law Clause of the Federal Constitution.

Perhaps we should be reminded at the outset of our discussion that the Commerce Clause does not by its terms restrict state taxation—it is merely a grant of power to Congress to regulate the commerce; and that it was not until after the Civil War that the Commerce Clause was invoked to invalidate a state levy. There are students of constitutional law who hold that until Congress acts, the States are free under the Commerce Clause to levy non-discriminatory taxes on interstate businesses. This view, however, has not prevailed; and instead it has long been established that the Commerce Clause has a self-operating immunizing effect and that state and local levies may be invalidated in the silence of Congress as undue burdens on interstate commerce.

Traditional view of Commerce Clause

The traditional view established by Supreme Court decisions was that interstate commerce may not, in the absence of authorization by Congress, be taxed by the states; and that the Commerce Clause creates an area of trade free of state taxation. Under these principles, the court invalidated taxes imposed directly on any phase of interstate commerce, as well as all levies which discriminate against the commerce. The states were, however, permitted to impose taxes on property located or used in the state, albeit solely in interstate commerce, as indirect levies on the commerce, but property taxes were invalidated as applied to goods moving in the stream of commerce. The States were upheld in applying gross receipts taxes to interstate railroads and express companies and telegraph companies where the levies were imposed in lieu of property taxes. But license taxes, franchise, capital stock and other excises were prohibited under the Commerce Clause when applied to businesses exclusively interstate in character.

Emergence of multiple-taxation doctrine

The wave of political liberalism which swept this country from the first Roosevelt administration to the outbreak of World War II had a powerful impact on the Supreme Court. Many striking changes in the interpretation of the Federal income tax laws were made by the court in that period. *Gregory, Clifford, Court Holding Company* and *Tower* and *Lusthaus* were among products of that era. In the field of State taxation, it was inevitable that the new realpolitik, the re-evaluation of the roles of big and small businesses in our economy and the increasing reluctance of the Court to thwart the states in meeting modern economic conditions should result in a broadening of the power of the state to tax businesses carried on across state lines. A new cycle in the history of the taxing power of the states under the Commerce Clause was opened.

The chief architect of the new juridical structure was Justice Stone. He swept away the traditional view that under the Commerce Clause "interstate commerce may not be taxed at all" and that the Commerce Clause created an area of trade free of state taxation. In its place, he erected the multiple taxation doctrine under which interstate businesses were no longer immune from tax merely because the levy was imposed on interstate commerce or the receipts from the commerce. Instead, such levies would be invalidated only if the Court thought that they subjected interstate commerce to a risk of multiple taxation not borne by local commerce.

The permissible area of state taxation was broadened so as to sanction levies which were apportioned by methods which the Court thought were reasonably designed to measure the state's nexus with the receipts, income, or property taxed. Apportionment thus became one of the keys to the validation of state taxes. At the same time, the Court narrowed the area of what constitutes an interstate business or transaction. This was a natural result of measuring the interstate or local character of the business or activities taxed by the yardstick of multiple taxation. Unapportioned levies which the Court found did not subject interstate commerce to the prohibited risks of multiple taxation were increasingly de-

termined to be taxes on local incidents; only those levies which were found to run afoul the test of multiple taxation tended to be proscribed as taxes on interstate transactions.

Waning of new philosophy

The ascendancy of the multiple taxation doctrine was short-lived. The New Deal reform era ended; the great holocaust of war brought a new concentration of power in the central government and a vast new importance to large far-flung businesses. An overall constitutional retreat set in. With the irony of which the gods are capable, Justice Frankfurter, whose appointment had brought anguished outcries from many business circles, led the Court to repudiate the new Commerce Clause philosophy of the Coolidge-appointed Stone, and to resurrect the old order. Now a new majority exists—and key cases in this field typically involve only a slim majority whose decisions were rendered over strong dissent. This new majority has largely restored the doctrine that direct taxation of interstate commerce is repugnant to the Commerce Clause and that if a state tax is levied on interstate commerce, apportionment will not save it.[1]

It was in *Freeman v. Hewit*[2] that the Supreme Court invalidated, under the Commerce Clause, the Indiana gross receipts tax as applied to the receipts of an Indiana resident from sales of securities on the New York Stock Exchange through an Indiana broker, and used language which re-established the doctrine that direct taxes on interstate commerce are invalid, indicating that apportionment would not save such levies. It followed that decision by a holding that a tax on the privilege of doing business, measured by gross receipts could not be applied to a stevedoring company loading and unloading in New York City vessels which were engaged in interstate and foreign commerce.[3]

It was thought in some quarters that the Court was striking particularly at taxes imposed on or measured by gross receipts from exclusively interstate businesses. Traditionally, the Court had regarded gross receipts taxes as especially burdensome levies as applied to interstate businesses because they take their toll whether or not the taxpayer makes a profit. There had been earlier authorities which had established a constitutional framework for distinguishing between levies measured by gross receipts from those measured by net income, on the theory that gross receipts taxes are direct taxes and net income taxes indirect levies.[4]

This view, that the real vice in the levies thus held violative of the Commerce Clause was the gross receipts measure used, was given considerable force by the Supreme Court's affirmance of the decision of the highest California court in the *West Publishing Company* case.[5] In that case, California had imposed a net income tax on the taxpayer, a leading seller of law books, which maintained salesmen in the state, solicited orders which were accepted outside the state and shipped into the state directly to the customer. The salesmen collected payments on orders received by them, handled some delinquent accounts and looked after complaints. In sustaining the tax, the California court took the position that whereas a tax imposed on the privilege of doing business measured by net income would be invalid, a direct net income tax properly apportioned did not run afoul the Commerce Clause. The United States Supreme Court upheld the levy in a brief per curiam opinion, which may be construed either as meaning that it approved the California Court's views or in the alternative that the salesmen's activities constituted a local business taxable by the states.

Spector reconsidered

At this juncture, the celebrated *Spector* case reached the Supreme Court for the second time.[6] There, Connecticut had levied a tax on the privilege of doing business measured by net income allocated to the state. The taxpayer, a foreign coporation, operated an interstate trucking business with terminals and pick-up trucks and over-the-road trucks operated in Connecticut. A strong opinion by the Court of Appeals for the Second Circuit had taken the position that the distinction between a tax on the privilege of doing business measured by net income and a direct tax on net income as applied to interstate businesses had neither economic nor constitutional significance and that where the measure of the tax was properly apportioned, such levies were not repugnant to the Commerce Clause. The Supreme Court held otherwise, determining that the states are precluded from taxing the privilege of doing an exclusively interstate business, despite the allocated net income measure. The Court did not reveal its views as to whether a direct net income tax properly apportioned, as distinguished from a tax imposed on the doing of business, would be upheld.

"Exclusively interstate business"

In seeking to give content to the views of the current Supreme Court majority, as expressed in the decisions, we must round out two key questions: First, what is a *local* business, or a *local* incident of an interstate business which may form the subject of state taxation? Second, what is an *indirect* levy on an exclusively interstate business which will be upheld, as distinguished from a *direct* levy which will be abrogated?

In attempting to delimit the area of exclusively interstate business from intrastate business, a good starting point is the 1918 case of *Cheney Brothers Co. v. Massachusetts*,[7] which takes on added significance in view of the recent decisions. In that case, which actually involved six different taxpayers, the Court held that the solicitation of orders through local salesmen working out of a local office constitutes an exclusively interstate business immune from state taxation, but that local warehousing of goods out of such a warehouse is an intrastate business; that the maintenance of a local repair station to repair taxpayer's products is a local business, as is the sending of salesmen into the state by a manufacturer to assist its customers, who are wholesalers, to make resales to their customers.

Recent Supreme Court decisions have unequivocally reaffirmed the proposition that the solicitation of orders through salesmen maintained in the state, working out of a local sales office, where the orders are transmitted outside the state for approval and acceptance and for shipment to the customer into the state, is an exclusively interstate business not subject to local franchise or license tax.[8] And the New York courts have extended this view in the recent *United Piece Dye Works* case, so as to invalidate the New York City gross receipts tax as applied to a corporation which rendered extensive technical services to its customers in New York, advising them as to dyes and shades and printing of the goods. All this was held to be incidental to and a part of the immune solicitation of interstate sales.[9]

In businesses other than local selling, the process of drawing the line between the interstate and the local business has been tortuous and uncertain. Thus, an

interstate pipeline was held to be engaged in an intrastate business on the ground that its generation of electricity used in compressing the gas into the lines was a local activity separate from the interstate pipeline.[10] Likewise, whereas the movement of natural gas in high pressure lines from the gas wells across state lines is an interstate business, the movement of the gas into local supply mains at reduced pressure was held to constitute a local business.[11] Again, in the related sales tax field, the transfer of title and possession to property shipped interstate has been treated as local commerce, whereas the solicitation of the order and the shipment are regarded as interstate activities not locally taxable.[12] Manufacturing or producing goods for interstate shipment is a local activity preceding the commerce,[13] whereas a marketing agent selling interstate the produce of domestic fruit growers[14] and stevedores loading and unloading ships plying in interstate waters are engaged in interstate commerce.[15]

Use of legal fictions

It was not to be expected that the state legislatures and state courts would remain idle while the Supreme Court curtailed their power of taxation of the nation-wide businesses conducting large operations in their boundaries and reaping substantial revenues from the local markets. One method that has been used by the states with some success to ease these restrictions is an ancient and honorable legal device—the device of fiction. Fictions have played an important role in the law as a means of circumventing what the court regards as bad law without admitting to the act. Faced with the fact that a tax on the privilege of doing an exclusively interstate business would be invalidated as applied to a foreign corporation, the Mississippi Supreme Court in the *Memphis Gas* case resorted to fiction in construing its state franchise tax.

The Memphis Gas Case. The tax in question is explicitly levied on the doing of business in the state; it is a typical capital stock tax, measured by the value of the corporation's capital stock employed in the state. It was applied to an interstate pipeline which the state conceded was engaged solely in interstate business. Despite the language of the legislature in imposing the levy on "doing business", the state court nevertheless held that the tax was not levied on doing business, but instead on "the local activities in maintaining, keeping in repair and otherwise manning the facilities" of the taxpayer in the state, a local privelege which the State court held subject to tax. In a five to four decision handed down in 1948, the United States Supreme Court upheld the tax.[16]

Justice Reed, writing the principal opinion for the Court, concluded that the maintenance of the pipeline was sufficiently "separate and apart" from the commerce itself to warrant its treatment as a local activity subject to tax. This was a startling result—bitterly protested by Justices Frankfurter, Jackson, Burton and Chief Justice Vinson, who dissented—that an activity essential to and part of an exclusively interstate business could be made the subject of a local tax. What Justice Reed did was to extend the cases upholding property taxes on the instrumentalities of the commerce to the activity of maintaining such property. In so doing he announced a new doctrine that the states may tax activities which are part of an interestate operation, provided what they seize on is "apart from the flow of commerce."

Does the *Memphis Gas* case mean that the states may fragmentize the doing business conception and by taxing one fragment of the entire process succeed in imposing privilege, license, franchise or other excise taxes on interstate businesses? No—that is not the rule. Indeed, Justice Reed in the *Memphis Gas* case made it clear that the court would decide in each case whether the activity was sufficiently apart from the very "process of commerce" to warrant its being disjoined from the commerce and being made the subject of the tax. A recent Supreme Court decision[17] makes it clear, as has already been indicated, that the solicitation of sales by employees working in the state is an integral part of the process of commerce which may not be made the subject of a tax.

We may, I think, expect further attempts by the states to seize upon a single aspect of interstate business as a means of circumventing the *Spector* decision. In attempting to evaluate the state's chances of success, it should be noted that two of the five Justices who voted to sustain the levy in the *Memphis Gas* case are no longer on the bench, Justices Rutledge and Murphy; they have been succeeded by Justice Clark, whose opinions in Commerce Clause tax cases suggest that he is a follower of the Stone-Rutledge tradition,[18] and by Justice Minton, whose leanings appear to be in the direction of a more traditional approach to the field.[19] On the other hand Chief Justice Vinson, who was generally to be found on the more conservative side of the bench in Commerce Clause issues and who dissented from the decision in the *Memphis Gas* case has been succeeded by Chief Justice Warren, who appears to be leaning in this field with Justices Douglas, Clark and Black.[20] And Justice Jackson who voted in most of the split-decisions cases for restricting state taxation has been succeeded by Justice Harlan, who has not yet had an opportunity to reveal his thinking in this area. Conceivably, the *Memphis Gas* case may eventually be overruled, or, it may be limited to cases in which the measure of the tax is a property measure, such as a capital stock tax.

The Pennsylvania "Property" Tax. A second method of attempted circumvention of the restrictions of the *Spector* decision is to be found in Pennsyl-

[1] For studies of the Commerce Clause cases, see Powell, "Indirect Encroachment on Federal Authority by the Taxing Powers of the States," 31 *Harv. L. Rev.* 321, 572, 721, 932 (1921); 32 *Harv. L. Rev.* 234, 374, 634, 902 (1919); Brown, "State Taxation of Interstate Commerce—What Now?" 48 *Mich. L. Rev.* 899 (1950); Hartman, "State Taxation of Interstate Commerce (1953). See, also, Hellerstein and Hennefeld, "State Taxation in a National Economy," 54 *Harv. L. Rev.* 949 (1941); Hellerstein, "State Franchise Taxation of Interstate Business," 4 *Tax L. Rev.* 95 (1948); and Hellerstein, "State Franchise and Income Taxation of Interstate Commerce" (1953). See, *Executive* No. 6 (1954), from all of which I have freely drawn in preparing this paper.

[2] 329 U.S. 429 (1946).

[3] Joseph v. Carter & Weekes Stevedoring Co., 330 U.S. 422 (1947).

[4] See United States Glue Co. v. Town of Oak Creek, 247 U.S. 321 (1947).

[5] West Publishing Co. v. McColgan, 27 Cal. 2d 705, 166 P. 2d 861 (1946), aff'd 328 U.S. 323 (1946).

[6] Spector Motor Service, Inc. v. O'Connor, 340 U.S. 602 (1951).

[7] 246 U.S. 147 (1918).

[8] See Norton Co. v. Department of Revenue, 340 U.S. 534 (1951); Memphis Steam Laundry Cleaner, Inc. v. Stone, 342 U.S. 389 (1952).

[9] United Piece Dye Works Inc. v. Joseph, 282 App. Div. 60, (1st Dept. 1953) (Breitel, J.) aff'd. 307 N.Y. 780 (1954), certiorari denied 348 U.S. 916.

[10] Coverdale v. Arkansas Louisiana Pipe Line Co., 303 U.S. 604 (1938).

[11] East Ohio Gas Co. v. Tax Commissioner, 283 U.S. 465 (1932).

[12] McGoldrick v. Berwind-White Coal Mining Co., 309 U.S. 33 (1940).

[13] American Mfg. Co. v. St. Louis, 250 U.S. 459 (1919); Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938).

[14] Gwin, White & Prince, Inc. v. Henneford, 305 U.S. 434 (1939).

[15] Joseph v. Carter & Weekes Stevedoring Co., 330 U.S. 422 (1947).

[16] Memphis Natural Gas Co. v. Stone, 335 U.S. 80 (1948), discussed at length in Hellerstein, "State Franchise Taxation of Interstate Business," 4 *Tax Law Rev.* 95 (1948).

[17] Memphis Steam Laundry Cleaner, Inc. v. Stone, 342 U.S. 389 (1952).

[18] See dissenting opinion in Spector Motor Service, Inc. v. O'Connor, Note *supra*, and in Norton Co. v. Department of Revenue, 340 U.S. 534 (1951) and cases cited in Note 20, *infra*.

[19] See Railway Express Agency, Inc. v. Virginia, 347 U.S. 359 (1954); Miller Bros. Co. v. Maryland, 347 U.S. 340 (1954).

vania's new so-called property tax. For some years Pennsylvania has had a net income tax applicable to domestic and foreign corporations doing business in the state or having property or capital employed in the state; the tax is allocated under a three-factor Massachusetts type formula. To deal with the contingency that this tax may be held unconstitutional as applied to a foreign corporation engaged solely in interstate commerce, the Pennslvania legislature enacted a supplementary tax which it has entitled a "property tax." Only those corporations not subject to the income tax are subject to the so-called property tax. Unlike the income tax, the property tax is not levied on corporations "doing business" in the state but instead on corporations "carrying on activities" or "owning property" in the state. The attempt to bring the tax within the *Memphis Gas* decision is, of course, apparent. A singular feature of this "property tax" is that the measure of the levy is not "property" but net income—net income allocated to the state under the formula bearing a good deal of similarity to that used in the income tax; likewise, the rate is the same as the net income tax rate.

At first glance, one is tempted to dismiss the new levy as a mere spurious exercise in semantics, but on closer analysis it appears that Pennsylvania may have a firmer basis for its Commerce Clause avoidance technique than at first appears. When the Supreme Court invalidated the 1894 Federal income tax, it did so on the ground that the Federal constitutional requirement that direct taxes be apportioned among the states in proportion to population was violated.[21] The Court's theory was that a tax on income from property is a property tax and hence a direct tax violating the apportionment requirement. While later Supreme Court decisions have expressed doubts as to the notion that an income tax is a property tax,[22] nevertheless, some state Supreme Courts, including the Pennsylvania court, have invalidated graduated personal income taxes on the theory that they are property taxes and as such violate state constitutional requirements of uniformity or equality in taxation.[23] The first case arising under the new Pennsylvania so-called property tax involved a foreign corporation engaged in transporting freight by truck to and from Pennsylvania. The taxpayer in that case maintained no terminal in Pennsylvania, it solicited no business in the State, accepted no orders and received no payment in the State; no employees of the taxpayer, other than its truck drivers, operated in Pennsylvania. The Pennsylvania Supreme Court invalidated the levy without determining whether the tax should be considered an income tax or a property tax, on the ground that the States may not tax under the Commerce Clause a foreign corporation having no property and carrying on no activities other than those involved in taxpayer's trucking operation.[24] Supreme Court review was not sought by the Pennsylvania taxing authorities.

The Pennsylvania example has not been followed by other states, several of which have instead followed the California precedent by pressing the distinction between a franchise tax measured by net income and a direct net income tax.[25] We shall, I have no doubt, before too long, learn from the Supreme Court whether a tax designated a net income tax—as distinguished from a tax designated a levy on the doing of business—will be upheld as applied to income derived from sources within a state by a foreign corporation engaged exclusively in interstate commerce. It is not unlikely that the fate of the Pennsylvania property tax in the highest court of the land will, if pressed before that tribunal, depend less on the designation of the levy as a property tax than on the court's readiness or unreadiness to sustain a direct net income levy.

Inseperable inter-intrastate business

While the states have been seeking new methods of avoiding the current restrictive view of the Supreme Court in respect to state taxation of interstate business, a little noticed struggle is going on in the Supreme Court which may result in a further narrowing of the taxing powers of the states under the Commerce Clause. There has been at times language in some Supreme Court decisions to the effect that where interstate and intrastate activities are so inextricably intertwined that the intrastate activities could not be abandoned without giving up the interstate business, the states may not tax the conduct of the business at all, for to do so would in effect be to tax an interstate business. Nevertheless, despite such statements, at least since 1936, the law appeared to have been settled that an otherwise valid excise tax on a local activity or business will not be held void "merely because the local and interstate branches are inseparable."[26]

This issue arose strikingly in 1955 in a case involving the validity of a Chicago license tax as applied to a trucking company.[27] Significantly, the language of the majority of the Court in sustaining the levy refused to rest its holding on the notion that inseparability of local and interstate business will not invalidate the tax and instead the Court used qualifying language concerning the 1936 decision referred to of a character which often augurs ill for a precedent. Two Justices concurred specially by reaffirming the doctrine that inseparability will not invalidate the tax; one Justice—surprisingly Justice Douglas—dissenting, rejected the doctrine altogether. In another case involving an Illinois state tax on motor carriers, which the Court upheld the same day, Justices Frankfurter and Jackson dissented in language which strongly suggests their hostility to the doctrine that an integrated and inseparable local and interstate business may be subjected to state privilege taxes.[28]

The radio and television tax cases, which are likely to be presented afresh to the Supreme Court in view of the vast growth of those industries, may possibly afford the vehicle for determining whether the inseparability doctrine will furnish a fresh, reinvigorated basis for outlawing state taxes. There are cases of an earlier vintage holding that the privilege of conducting radio broadcasting which transcends state lines is an exclusively interstate operation beyond the reach of the taxing power of the States.[29] Yet operations are carried on by large radio and television stations, which cover more than one state but at the same time draw heavily on the local market. These would appear to be businesses whose local and interstate operations are inseparable.

One state court has dealt with the problem in a highly practical manner, although not entirely satisfactorily, by allowing a privilege tax on a radio

[20] See dissenting opinions in Railway Express Agency, Inc. v. Virginia, and Miller Bros. Co. v. Maryland, Note 19, *supra* and the majority opinion in Braniff Airways, Inc. v. Nebraska State Board, 347 U.S. 590 (1954).
[21] Pollock v. Farmers Loan and Trust Co., 157 U.S. 429 (1895).
[22] See New York ex rel Cohn v. Graves, 300 U.S. 308 (1937).
[23] Kelly v. Kalodner, 320 Pa. 180, 181 Atl. 598.
[24] Roy Stone Transfer Corp. v. Messner, 377 Pa. 234, 103A.2d 700 (1954).
[25] See Roesken, "State Tax Trends," 33 *Taxes* 131 (1955).
[26] Pacific Telephone and Telegraph Co. v. Tax Commission, 297 U.S. 403 (1936).
[27] City of Chicago v. Willett Co., 73 S. Ct. 460 (1953).

station whose broadcasts covered sixteen states, but limiting the measure of the tax to receipts from what it regarded as essentially local broadcasts, i.e., broadcasts originating locally and sponsored largely by local advertisers. But it invalidated the levy as applied to network programs and nationally sponsored advertising. Both types of programs were, of course, heard in all sixteen states. The court recognized that there are authorities to the contrary but took the view that receipts from local broadcasting and from local people should be locally taxable.[30] We must await further Supreme Court action to ascertain whether the court will reinstate the inseparability doctrine and thereby further cut down the power of the States to tax interstate businesses.

The de minimis doctrine

An interesting sidelight on this problem was furnished by the New York courts in the *United Airlines* case, decided in 1953.[31] There the City of New York sought to apply its tax on the doing of business or carrying on commercial activities in the city, measured by allocated gross receipts, to United Airlines, which carries only interstate traffic in the city. The airline actually carries on large operations in the city, where it maintains one of its principal terminals, traffic offices, a hangar, a repair and maintenance shop, and a stock room of parts and supplies. All these were held by the court to be essential parts of the interstate operation and therefore such activities could not be made the subject of a local tax. In addition, United Airlines sold some airplane parts to other airlines and provided maintenance for other airlines, which produced an annual revenue of about $12,000.

United Airlines is also a member of Airlines Clearing House, and as such sells in New York City tickets for intrastate passage on other lines. These activities were concededly intrastate; indeed, United had paid the disputed tax thereon, thereby recognizing that it was doing an intrastate business.

The Court, however, dismissed these activities as *de minimis* and held that they could not lay a foundation for subjecting to tax the $5,000,000 to $6,000,000 of annual transportation revenues out of $18,000,000 to $27,000,000 throughout the country which the city sought to tax. This decision seems to be based on a misreading of Supreme Court decisions. The cases do not support the Court's statement that a gross receipts tax for the privilege of doing intrastate local business must be reasonably and at least approximately apportioned in relation to the local incidents which have resulted in the taxpayer being subject to the tax. On the contrary, the law has long been established that once a local business is carried on, the state now having a local subject of tax, may measure that tax by the receipts from exclusively interstate operations, which could not previously have been made the subject of the levy.[32] And when the court seeks to justify this result by applying the *de minimis* rule, it is breaking new ground in restricting state taxation under the Commerce Clause.

The Court's opinion and decision, though not supported by the cases, are supported by logic. If the airline's transportation activities may not be taxed by the state because to do so would unduly burden the commerce, it would seem reasonable that local sales of parts should result only in a tax measured by such sales, whether $12,000 a year or $12,000,000 a year, and that the transportation receipts should be non-taxable.

The logic of this position, however, reveals the unreality of the entire doctrine, reaffirmed in the *Spector* case, that a tax on the conduct of an exclusively interstate business, though fairly allocated to the business done in the state, violates the Commerce Clause. For the foundation of the doctrine is that where a business is exclusively interstate in character, the state has no *taxable subject* on which to seize. The existence, however, of minor repairs or an insubstantial volume of intrastate sales establishes the requisite locally *taxable subject;* and once there is a privilege or business to be taxed, the previously immune interstate sales or transportation or other activity may now be included in the measure of the tax (limited, of course, by appropriate apportionment methods.) All this indicates that the entire *Spector* doctrine adjudges "burden" by an unreal conceptualism which has no place in modern constitutional law. If economics rather than metaphysical standards of "burden" are to govern constitutional law, then either the measure of a franchise or income tax should be constitutionally limited to the property, receipts or income applicable to the locally taxable subject or such excise taxes should be permitted as applied to all businesses, irrespective of their exclusively interstate character, limited by a proper allocation to the state.

Discrimination against interstate commerce

The Court has always been astute to strike down under the Commerce Clause levies which are designed to discriminate against or have the effect of discriminating against interstate businesses; and here there is no essential disagreement among the Justices. A 1954 decision invalidating a Texas tax applied to a pipe line company received the unanimous approval of the court because, I suspect, some members of the bench regarded the levy as essentially directed against the interstate operator.[33] The tax was imposed on the gathering or taking of possession of natural gas by the pipeline from the producer. This occurred as the gas flowed from the producer's pipeline into the taxpayer's pipeline several hundred feet from the well. The Court held that this gathering of the gas constituted its "taking off" into commerce for transportation to Wisconsin and Michigan, and that "in reality the tax is therefore on the exit of the gas from the state." The Court refused to separate the taking of the gas from the well owner, the compression and scrubbing of the gas by the taxpayer at its local station before passing it into its own pipeline as a locally taxable event, a result which could readily have been reached under prior decisions. It may be surmised that Justice Black and perhaps some other Justices went along with the majority for reasons not mentioned, namely, this tax is subject to the very vice so long used to discriminate against interstate and out-of-state businesses. Here was a selective levy directed specifically at a single industry, not businesses generally, an industry the bulk of whose product flows into other states, so that Texas in effect was seeking a tax to be borne by natural gas users in other states.

[28] Bode v. Barrett, 73 S. Ct. 468 (1953).
[29] Fisher's Blend Station, Inc. v. State Tax Commission, 297 U.S. 650 (1937).
[30] Albuquerque Broadcasting Co. v. Bureau of Revenue, 51 N.M. 332, 184 P. 2d 416 (1947); see also, same case, in 59 N.M. 201, 281 P. 2d 654 (1955) appeal dismissed for want of a Federal question 76 Sup. Ct. 73 (1955); see also, Hartman, *op. cit.* Note 1, *supra.*
[31] United Airlines, Inc. v. Joseph, 282 App. Div. 48 (1st Dept. 1953) (Breitel, J.) aff'd. 307 N.Y. 762 (1954).
[32] Cheney Bros. Co. v. Massachusetts, Note 7, *supra* and Spector Motor Service, Inc. v. O'Connor, Note 6, *supra.*
[33] Michigan Wisconsin Pipe Line Co. v. Calvert, 347 U.S. 157 (1954).

Inadequacy of judicial solution

A review of the judicial history of state taxation under the Commerce Clause strongly suggests that the Supreme Court is not a satisfactory arbiter of the competing demands of a national economy, the revenue requirements of the states, and the need of local businesses to have their national competitors bear a fair share of state and local tax burdens. All agree that discriminatory levies against interstate business should not be tolerated. Beyond that there appears to be little justification for the immunity of interstate business from a fairly allocated franchise or capital stock tax, whether measured by gross receipts, capital stock or net income. And who, except by reference to highly conceptual notions of constitutional law, unwarranted by the economic facts of life, can distinguish between a properly allocated net income tax and a privilege tax measured by net income? Semantics should not decide important issues of sovereign taxing power. The court's distinctions between the local and interstate business, between the local incident and the "very process of the commerce" have produced confusion, uncertainty, endless litigation and results of dubious justification. Moreover, it is not a happy situation when the states are encouraged to resort to fictitious devices such as those involved in the *Memphis Gas* case and the Pennsylvania so-called property tax in order to meet their revenue needs.

Probably the most satisfactory judicial solution in our history to the Commerce Clause taxation problems was made during the brief and uncertain reign of the multiple taxation doctrine. Theoretically, that doctrine pointed towards equality of taxation of interstate and local businesses. In practice, however, the multiple taxation doctrine fell far short of its goal because of the weakness of its cornerstone—apportionment. The Supreme Court has upheld, and properly so, virtually every apportionment formula which does not transgress the outer limits of decency. The result is, for example, that states like Michigan, Ohio and New Jersey with their heavy concentration of plant and equipment could allocate franchise, capital stock or corporation income taxes by reference to a single factor property formula or a two-factor property and payroll formula and thereby obtain the lion's share of the tax measure, while the state of the market may allocate by reference to factors emphasizing local sales. The result of such apportionment would be to impose disproportionate levies on nationwide businesses. In fact, in view of the wide variety of apportionment methods used by the States, apportionment falls far short of achieving equality.

It is inevitable, as the Supreme Court itself has frequently recognized, that the judiciary operating under the Commerce Clause and the related Due Process Clause cannot deal adequately with the complex and delicate accommodation of the needs of national and state businesses and the requirements of the local fisc. The judiciary is not equipped by experience, or by its mode of operation within the confines of the single case presented and the record on which the case is made, or by its limited powers under the Constitution to grapple with the problems presented. Some attempts to deal with these problems have been made through cooperative action among the states, but this is a painstakingly slow process which the conflicting interests of the several states have impeded.

The powers of Congress

There is, however adequate constitutional power in Congress to deal with state taxation under the Commerce Clause, a power which Congress has to date largely failed to exercise. There are some instances of the use of the power of Congress in the area—e.g. Congress has authorized the states to apply unemployment insurance taxes equally to interstate and local businesses, and it has enacted legislation facilitating the collection of state taxes on interstate shipments of cigarettes, but by and large the vast Congressional power to regulate commerce has gone unexercised in respect to State taxation.[34]

Congress could, for example, establish an administrative agency charged with the duty of promulgating uniform allocation formulae and methods; the legislation could provide that no state may impose certain specified levies on a business engaged partially or wholly in interstate commerce, unless it adopts the allocation methods prescribed by the administrative agency. In the field of sales and use taxation, the Commission might be empowered to designate one state alone—e.g., the state of the market—as the state which may tax a sale involving the shipment of goods across state lines, or it could provide for a division or allocation of the tax between the states involved. I am not undertaking to suggest the methods to be employed by the type of Federal tax commission to which I have referred, but only to indicate in broad terms the possibilities of such an expert Commission familiar with the various facets of the problem and working closely with both the states and businesses. Congress would not dictate the types of levies or rates of tax to be imposed but it would through an expert agency, prescribe uniform allocation methods for similar taxes or perhaps designate a single state for the imposition of specified types of taxes which the States would be bound to apply if they sought to tax interstate businesses.

Congress also has other powers which have been used in the past and could be used in this area. Thus, the Congressional taxing power can be invoked, as has been done in the Federal estate tax credit for local death taxes and in the unemployment insurance tax field. And the Federal spending power affords possibilities through subsidies and grants in aid to the states conditioned on the states' enacting tax legislation prescribed by Congress. I would not be quick to advocate the use of these powers in the interstate commerce taxation field for I recognize the dangers inherent in possible Federal control over state and local taxing systems. Overall, the exercise of Congressional powers under the Commerce Clause, acting through an administrative agency empowered to deal with State taxes imposed on interstate businesses by means of allocation methods and the designation of the appropriate taxing State appears to me to offer the most likely area of solution to the vexing problems of State taxation under the Commerce Clause. ☆

[34] A discussion of the powers of Congress in this area and an elaboration of the proposals made in the text may be found in Hellerstein and Hennefeld, "State Taxation in a National Economy," 54 *Harv. L. Rev.* 949 (1941); see, also Hartman, *op cit. supra*, Note 1.

Pa. determines taxable situs of cash, receivables

THE TAXABLE SITUS of intangibles—cash and receivables—has now been definitely established for capital-stock-tax purposes, at least in Pennsylvania. In *Commonwealth v. Universal Trades, Inc.*, the Dauphin County court has ruled that the taxable situs of such intangibles is the domicile of the owner. Robert G. Yinger reported the case recently in the

Pennsylvania *CPA Spokesman* this way:

"The taxpayer, engaged in construction work for the federal government, was incorporated in Pennsylvania, using Ambridge, Pennsylvania, as its registered office. From the time of its incorporation *all* of its corporate activities were carried on in Florida. It argued that, because *all* of its activities were without the Commonwealth of Pennsylvania, the intangible assets had acquired a commercial or business domicile without the state; therefore they had no situs within the state. Taxpayer argued also that, being without the state, these intangibles could not be taxed, since to do so would be a violation of the due process clause of the XIV Amendment of the Constitution of the United States.

"In reply the court stated: '. . . It has been argued that the defendant derives no benefits or protection from the Pennsylvania laws. They, however, would have no right to engage in business save for those laws. They could not contract. They could not sue. They could not own intangible or other property without the right granted by Pennsylvania. In fact, they would not exist.'

"The court, when reviewing a number of other cases covering this particular question where the facts were not as clear-cut, further stated:

" 'These opinions are remarkably consistent. They uniformly hold that the tax situs of intangibles is the domicile of the owner, be he an individual or corporation. If the owner is not domiciled here, intangibles are not taxable here. But if the owner is domiciled here, intangibles are taxable here. The reported cases show no exceptions, deviations or distinctions. It is our opinion, therefore, that the intangibles here involved are taxable by Pennsylvania and that the amount of the tax was correctly determined." ☆

North Carolina CPAs study state tax system

EXTENSIVE recommendations for improvement of the Revenue Act of North Carolina have been made by the North Carolina Society of CPAs, on the invitation of the Commission for the Study of the Revenue Structure of the state. In this unusual public service, the CPAs have made studies leading to recommendations affecting the income, franchise, intangible, inheritance and gift taxes, as well as tax administration.

We are glad to note that our colleague, Charles S. Lowrimore, of Wilmington, editor of the Tax Planning Department of THE JOURNAL OF TAXATION, was chairman of the subcommittee concerned with income taxes of individuals, partnerships, and fiduciaries.

Tax men in other states interested in improving their own state's tax structure could benefit from study of the North Carolina CPA's report. A few copies are available; if you can use one to advantage write the Society at Chapel Hill, N. C. ☆

Tax Institute to study highway taxes

THE ANNUAL MEETING of the Tax Institute will be held in Princeton, N. J., November 8 and 9. Subject of discussion will be "Financing Highways" and related tax considerations. ☆

New decisions

Can apply allocation formula by combining figures of affiliated companies. Practically the total production of a California winery was sold to a bottling and distributing corporation incorporated in Nevada, which owned the total stock of the producing corporation. The state of California imposed income taxes; it applied an allocation formula to the combined net income of the two corporations on the basis that their operations constituted a unitary enterprise. In upholding the assessment, the California Board of Equalization ruled that the two corporations had unity of ownership, unity of operation and unity in the use of centralized executive force and general system of operation. The Board dismissed taxpayer's argument that the formula produced an unreasonable result, since, although all but small fractions of its sales were made outside the state, 20% of the income was allocated to California. The Board also upheld the inclusion, in the property factor, of the inventory stored in the California winery's warehouse but owned by the parent corporation. *Gibson Wine Co.*, Calif. Bd. of Equalization, 6/22/56.

Computation of NC operating loss. In its 1949 fiscal year, taxpayer, a foreign corporation doing a multistate business, had incurred to North Carolina income tax liability. It lost more than $1 million from its unitary operations, although it received $185,000 in nontaxable unitary income. North Carolina's income tax law permits taxpayers to deduct the "net economic loss" of prior years in determining current taxes owed. It defines the term as the amount by which deductions for business purposes exceed income from all sources including any income not taxable under the act. It further provides that a net economic loss may be claimed as a deduction only to the extent that it exceeds any nontaxable income received by the taxpayer in the year it claims the deduction.

The Commissioner ruled that the statute required the loss carryover to be computed as follows. First, the loss for 1949 should be reduced by the nontaxable income for that year and then apportioned to North Carolina. This amount should be further reduced by the portion of 1950 nontaxable income apportioned to the state. The resulting figure is the net carryover allowed. The court agreed. *Dayton Rubber Co.*, Sup. Ct., NC, 5/23/56.

For Kentucky income tax purposes, Federal income taxes paid by a corporation doing an interstate business are deductible from gross income rather than net income allocable to Kentucky. The taxpayers had contended that the deduction for Federal taxes was to be made after all other deductions were taken and net income taxable by Kentucky was apportioned. The court finds no statutory basis for this contention. *Nashville R.R.*, Ky. Ct. App., 5 1/8/56.

Correction: In connection with the article published here in September by Robert E. Friou, we neglected to point out that it was written in December 1955, and should not be construed to comment on matters transpiring after that date. *Editor.*

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Rules affecting income in respect of decedent are changing in subtle ways

by **JAMES H. KINDEL, JR.**

THE COMPLICATED RULES which determine what is income in respect of a decedent, and how it shall be taxed, are changing, even though the new Code does not change the definition of what is such income. In approaching a determination of income in respect of a decedent, it is necessary to bear in mind that the Revenue Act of 1934 provided that all items of income of a cash-basis taxpayer which were accrued at the date of death should be accrued on the final return of the deceased and treated as income on that return. Deductions were to be similarly accrued. However such accrued items might represent payments which would otherwise have been received and taxed over a period of several years, the result was to tax the income at a higher rate than would otherwise have been the case. The Revenue Act of 1942 corrected the inequity resulting from this bunching of income by making such items taxable to the person entitled thereto when the payments were received. This Section 126 of the 1939 Code, with changes, is now Section 691 of the 1954 Code.

It might appear that the nature of "income in respect of a decedent" can be found within the definition of the term "accrued." However, the courts have applied a broader definition than is customarily assigned to this term. For example, in *Helvering v. Estate of Enright*,[1] which was decided under the 1934 Act, there was included in the return of the decedent an amount representing the value of services rendered but not billed by a law partnership on a cash basis of which the decedent was a member. The decedent was entitled to receive payment from the partnership for the value of such unbilled accounts under the terms of the partnership agreement. This amount would not have been accruable at the date of death of the decedent even though the partnership had been on an accrual basis. The court stated with regard to the meaning of the term "accrual":

"It has been frequently said, and correctly, that Section 42 was aimed at putting the cash-receipt taxpayer on the accrual basis. But that statement does not answer the meaning of accrual in this section. Accounts kept consistently on a basis other than cash receipts might treat accruals quite differently from a method designed to reflect the earned income of a cash-receipt taxpayer. Accruals here are to be construed in furtherance of the intent of Congress to convert into income the assets of decedents, earned during their life and unreported as income, which on a cash return would appear in the estate returns. Congress sought a fair reflection of income."

Concept extended

Income in respect of a decedent has been extended by later decisions considerably beyond the concept of "accrual" even under the interpretation of the court in the *Enright* case. In *O'Daniel*,[2] a bonus which was not fixed at the date of death of the decedent and to which he did not at that time have a legally enforceable right was included in the taxable income of the estate. The Circuit Court stated:

"The amount of $28,143.65 was plainly gross income in respect of the decedent which had to be included in the taxable year when received for the reason that the right to receive it was 'acquired by the decedent's estate from the decedent' within the meaning of Section 126(a)(1)(A). It is true that the decedent would not have had a legally enforceable right to receive the foregoing amount until it was allocated by the company, but the payment clearly represented compensation for his services and any right to receive it that was realized by his estate was acquired through him and never arose in any other way or through any other source."

The reasoning of the court in the *O'Daniel* case was relied upon in *Linde*,[3] which may have extended the concept even further.

The fact that an item is income in respect of a decedent does not necessarily mean that it will be includible in the estate tax return of the deceased. For example, amounts payable as a bonus to which the decedent had no legal right at the date of his death would not be subject to estate tax[4] but would be considered as income in respect of a decedent.

The problems arising in connection with income in respect of a decedent do not concern only cash-basis taxpayers. One of the reasons for the enactment of the provisions of the 1934 Code was the difference between the manner in which such items were taxed to a person or estate receiving property from a deceased (1) accrual-basis taxpayer and (2) cash-basis taxpayer. However, insofar as items which are income in respect of a decedent go beyond the definition of "accrued" in the customary accounting sense, the problem concerns both accrual- and cash-basis taxpayers.

Specific classes

Some of the classes of property which have been considered as income in respect of a decedent are:

Alimony. The collection of alimony due to a deceased divorced wife was held income taxable in her estate.[5]

Litigation. Amounts collected by the executrix of a decedent's estate as a result of litigation concerning profits due from a joint venture were held to constitute gross income to the estate.[6]

Contract. Payments after death under a legally enforceable contract calling for payments to the widow were held to be income in respect of a decedent.[7]

Interest. Accrued interest is stated to be income in respect of a decedent.[8]

Renewal Commissions. The renewal commisions due to an insurance agent are considered to be income in respect of a decedent.[9]

Accounts receivable. Amounts receivable from the sale of magazines, all of

which represented profit or income, were held to be income in respect of a decedent when those accounts were sold by the estate.[10]

Partnership. In *Estate of Taylor*,[11] the decedent was a partner in a business engaged in insurance and underwriting. The partnership agreement provided that the estate had the option to become a partner with the surviving partners on the same basis as the decedent for a period of 2,831 days. The estate exercised the option, treated the right as a capital asset, and claimed an allowance for depreciation against the income received from the partnership business. The court held that inasmuch as the partnership was engaged in a personal-service business and the partners had contributed no capital, there was no capital asset received from the decedent and the amounts received under the agreement constituted income.

Patents. Interesting questions arise with regard to the manner in which income from the sale or licensing of patents will be taxed. In the event the sale of the patent is made prior to the death of the decedent and if payments are being made which would be treated as capital gain under *Myers*,[12] or Section 1235 of the 1954 Code, the receipt of such payments by the estate of the decedent or other person entitled thereto would result in capital gain in the same manner as had been the case for the decedent. If the agreement is made before death and is a licensing agreement which does not qualify as a sale, the question is whether the patent would acquire a cost basis under Section 1014 of the 1954 Code at the death of the decedent.

Under the present law, where a sale of a patent is made by a decedent the gain will be taxable to his estate or the person entitled thereto in the same manner and to the same extent as it was to the decedent. If the decedent entered into an agreement which did not qualify as a sale, but was a license, then, while the payments will be ordinary income rather than capital gain, the patent will acquire a cost basis, the amortization of which should substantially reduce taxable income.

Capital gains. The amount to be included in income is gross income.[13] Payments of interest, salary, and similar items would result in the full amount received being considered as income. In the case of a sale of property made by the decedent, the amount by which the sale price exceeds the cost basis to the decedent would be the amount to be included in income. In addition, the income retains the same character it would have had if received by the decedent.[14] Accordingly, capital gain remains capital gain, and exempt income would remain exempt. The usual rule that basis of inherited property is value at date of death does not apply to items which are income in respect of a decedent. This is now set forth in the section of the law relating to basis, whereas prior to the 1954 Code the only reference to this problem was in the Regulations.[15]

Inventory. Problems arise, however, with regard to some classes of items. Property which the decedent sold in the usual course of his business has been treated by the Commissioner as not acquiring a new basis. However, neither the Commissioner nor the courts appear to have attached any significance to the fact that the decedent regularly sold such property in his business. In the *Burnett* case, arising under the 1934 law, the Commissioner proposed including in the final return of the decedent the value at the date of his death of cattle which had been raised by the decedent. The decedent was in the business of raising and breeding cattle and had charged to expense all the costs of raising the cattle. The Tax Court held that inasmuch as the cattle were merely owned by the decedent at the date of his death, that is, they had not been sold at that date, the increase in value was not subject to tax on the final return of the decedent.

In the *Linde* case, arising under Section 126 of the 1939 Code, the decedent was a member of farm cooperatives which processed grapes and sold wine for the members of the cooperatives. At the date of death, the decedent had turned over to the cooperatives grapes which had been processed into wine by the cooperatives but the wine had not been sold. The circuit court held that proceeds from the sale of the wine would result in income under Section 126.

If this decision could be considered as based upon the practical effect of the transaction between the decedent and the cooperative, which was similar in many respects to a sale, or based upon the existence of the contract with the cooperative which resulted in the sale, then the decision in the *Burnett* case may still be applicable. However, the circuit court cited the *Burnett* case, and while it did not expressly disagree with that case, there is at least the implication that it would not reach the same conclusion with the same set of facts. Furthermore, the court stated that the fact that there was or was not a sale would make no difference.

However, Congress apparently intends that inventory of a partnership will acquire a new basis and not result in income in respect of a decedent when it is sold. In the report of the Committee of Finance of the Senate concerning Section 753 of the 1954 Code, it is stated that while amounts payable as mutual insurance and for unrealized receivables under the provisions of Section 736 will be considered as income in respect of a decedent, "the provisions relating to income in respect of a decedent are not applicable to a decedent's interest in partnership inventory." It would accordingly appear that inventory would get a new cost basis equivalent to the value for federal estate tax purposes and that the sale of the interest of the decedent in such inventory would not result in income in respect of a decedent.

In order to adjust for the inequity of the same item being subject to both income and estate taxes, a deduction is allowable for the estate taxes attributable to the item of income. In determining the amount of the deduction for this purpose, account must be taken of deductions which are allowed for both income and estate tax purposes. The manner in which the deduction for estate tax is computed has been carefully analyzed elsewhere.[16]

Successive decedents

The 1954 Code has not made any change or clarification in the law with respect to the definition of what is income in respect of a decedent. How-

[1] 312 U.S. 636 (1941).
[2] 10 TC 631 (1948), *aff'd*, 173 F.2d 966 (2d Cir. 1949).
[3] 213 F.2d 1 (9th Cir. 1954), *rev'g* 17 TC 584 (1951).
[4] Estate of Jack Messing, TCM Dec., Aug. 18, 1948.
[5] Estate of Narischkine, 14 TC 1128 (1950), *aff'd*, 189 F.2d 257 (2d Cir. 1951).
[6] Troundstine, 18 TC 1233 (1952).
[7] Estate of Davis, P-H TC Mem. Dec. ¶52,238; CCH Mem. Dec. ¶19,136(M) (1952).
[8] Reg. 118, Section 39.126(d).
[9] Estate of Remington, 9 TC 99 (1947).
[10] Dixon v. United States, 96 F. Supp. 986 (1950), *aff'd*, 102 F.2d 82 (6th Cir. 1951).
[11] 17 TC 627 (1951).
[12] 6 TC 258 (1946).
[13] Section 691(a)(1).
[14] Section 691(a)(3).
[15] Reg. 118, Section 39.126(e).
[16] See Drye, *The Taxation of a Decedent's Income*, 8 TAX L. REV. 201 (1953).
[17] See "Income in Respect of Decedents as Affected by the 1954 Internal Revenue Code," by Lawrence E. Irell; Proceedings of the Seventh Annual Institute on Federal Taxes, University of Southern California Law School, p. 535.

ever, there have been many important changes.[17] The 1939 Code made no provision for successive decedents. An example given in the Committee Report illustrates the problem. If the decedent was a life-insurance agent who had a right to receive renewal commissions, then on his death these commissions would go to his widow as income in respect of a decedent. The right to receive the income would be taxed as an asset of the estate at its fair market value. For income tax purposes, the commissions would be taxed to the widow as received and not bunched in the final income tax return of the decedent or his estate.

However, upon the subsequent death of the widow, under Section 126 of the 1939 Code, the uncollected commissions were accrued and taxed in the final income tax return of the widow. Section 126 did not expressly state that it had no application to successive decedents, but it did provide that in case of a transfer by the decedent's successor in interest all of the income not yet received had to be accrued in the income of the transferor. The death of the decedent's successor (in the illustrated case, his widow) was construed to be a transfer within Section 126.

Under the 1954 Code, income in respect of successive decedents will be treated the same as income in respect of a first decedent. Section 691(a)(2) provides that the term transfer "does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent, or by bequest, devise, or inheritance from the decedent." It appears to be clear that it is still the law that a transfer by the widow during her life of the right to receive the commissions would require the accrual of the uncollected portions at their then fair market value in her income tax return.

Although most property included in the estate tax return of the decedent receives a new basis in the hands of the recipient, a right to receive income does not get a new basis as a result of its inclusion in the estate tax return. The result is that income in respect of a decedent is taxed at its fair market value in the estate of the decedent and the income is also taxed as income when received by the recipient. Under 1939 Code Section 126(a), the decedent's successor was entitled to a deduction against such income on account of the estate tax attributable to it. This is still the general rule, but because of the new provisions for successive decedents each of the successors in interest now is entitled to a pro-rata share of the income tax deduction attributable to the inclusion of the right to receive income in the estate tax return of his decedents. In the case of the insurance agent cited, on the death of the widow, her heir would be entitled to a deduction against the income he reports for any amounts of estate tax paid both in the estate of the original decedent and his widow on account of such income.

Amounts which are includible in the gross income of a successor in interest of a deceased partner under Section 736(a) are stated to be income in respect of a decedent by Section 753.

Installment obligations are now treated as income in respect of a decedent and retain the same character in the hands of the recipient as they did in the hands of the decedent. Formerly the uncollected portion of such obligations was accrued in the final return of the decedent unless an election was made and a bond filed with the Commissioner. The requirement of the bond has been eliminated. The recipient of the right to receive the installment obligations will be entitled to an income tax deduction for estate tax paid on account of the inclusion of the right in the estate tax return of the decedent. This rule is also applied with regard to the recipient of employees restricted stock options.

How annuities are taxed

The 1954 Code has changed the manner in which annuities are subject to taxation. As a result it has been necessary to make provision for a deduction by a surviving joint annuitant of estate taxes attributable to the portion of the annuity which is considered income in respect of a decedent. The law provides that the excess of the value at the date of death of the decedent over the amount which is excludable from the income of the surviving joint annuitant shall be considered as income in respect of a decedent for purposes of computing the deduction. The estate tax attributable to this excess is allocated over the life expectancy of the surviving joint annuitant and the allocated amount is allowed as a deduction in computing the income of the surviving joint annuitant for each year during which he receives payments under the annuity. However, if the surviving joint annuitant lives longer than his life expectancy the deduction is allowable only up to the time he attains his life expectancy or, if he dies prior to that date, the deduction is not available to his estate or any beneficiary after his death.

New treatment of distributions

Distributions by estates or trusts of income in respect of a decedent will be treated differently than under prior law. Amounts distributed to a beneficiary are deductible by an estate or trust and taxable to the beneficiary to the extent that the estate or trust has distributable income. The former requirement of determining whether the distribution was from income or corpus is eliminated.

Income in respect of a decedent distributed to a beneficiary by an estate or trust retains the same character to the beneficiary that it had to the estate or trust. The deduction for estate tax attributable to such income is allowed to the beneficiary if the income is distributed.

Advantageous planning

The 1954 Code makes it relatively simple for surviving partners to make payments for the decedent's interest which will be deductible from income and acquire thereby a share in the goodwill. Such payments are deductible unless they are specifically stated to be for goodwill. The purchase of goodwill, however labeled, would ordinarily represent a capital expenditure. There is a substantial difference to the estate or widow with regard to the income tax which will be assessed on such payments. If the partnership agreement provides for payment for goodwill, then the asset "goodwill" would be included in the estate of the decedent, and it would acquire a cost basis. It apparently would be necessary that there be goodwill and the agreement does not merely recite a fact which cannot be supported. The payment for the value of the goodwill in such case would not result in any income. If the payments are made in such manner as to be deductible by the partnership and taxable to the widow, the same amount of estate tax would be payable but the widow would pay income tax on the payments when received. Credit would of course, be allowed for the estate tax attributable

to such items but the additional cost to the widow might be substantial.

Consideration should be given in planning an estate to items which will be considered as income in respect of a decedent. For example, care should be taken to be sure that, if large amounts of income are to be received as income in respect of a decedent, such income will be received over a period of years, allocated to a number of taxpayers, or bequeathed to a charitable beneficiary.

If a partner is to receive a substantial payment which will be income in respect of a decedent under the provisions of Sections 753 and 736 of the 1954 Code, such payments should be made so that the tax rate will be as favorable as possible. For example, if a partnership agrees to pay $100,000 to a deceased partner in such a manner that it will be income in respect of a decedent, the partnership may take out insurance for this purpose. If this full amount were paid to the estate of the decedent in a single year it would result in the assessment of a very high tax. Such a payment should usually be made over a period of years.

If a person intends to make a charitable bequest, consideration should be given to providing in his will for the assignment of items which would be income in respect of a decedent in satisfaction of such bequest. In such case, such items would escape both income and estate taxes. ☆

[*James H. Kindel, Jr., Los Angeles attorney, is a member of the California State Bar. This article is based on a speech delivered at the 1955 Form Forum on Tax Problems Affecting a Family Estate, Los Angeles.*]

Miscellaneous new decisions this month

Mutual savings banks may deduct book addition to bad-debt reserve. Including the reserve for bad debts in the amount of surplus on a published statement will not prevent a mutual savings bank, etc. from taking a tax deduction for the addition to the reserve, provided the deduction is reflected in the books of account. *Rev. Rul.* 56-404.

Can't deplete cement rock beyond chemical treatment, though not yet marketable. Taxpayer mined cement rock (a mineral), chemically treated it, and sold it as cement—the first marketable product. The court sustains the Commissioner in refusing depletion on sales value beyond the chemical treatment. Although the Code allows depletion up to the point where a marketable product is produced, depletion is allowed on mineral products only. Hence no depletion is proper beyond the chemical conversion. *Dragon Cement Co.*, DC Me., 8/24/56.

Australian tax qualifies for credit. The tax on dividends imposed by the Australian income and social security law is a tax on shareholders. A taxpayer paying this tax may claim a foreign tax credit for it. *Rev. Rul.* 56-288.

80% partner's activities here put foreign partnership in business. Taxpayer came to this country to represent his foreign partnership in buying autos and equipment. Technically, title passed in the U. S. from the partnership to the ultimate user—the Argentine Government. The district court held that sales were not made in the U. S. and that the partnership was therefore not taxable on the profit. This court reverses. The partner was far more than a mere purchasing agent, and the partnership was engaged in business here. The court says it need not determine whether mere technical passage of title here would make the profit "from U. S. sources." The substance of the sales occurred in the U. S. *Balanowski*, CA-2, 8/14/56.

Canadian not taxed on distribution from qualified pension trust. Distribution received by Canadian beneficiary from qualified pension trust on death of Canadian employed in Canada by U. S. corporation is tax exempt. Under U. S.-Canada tax treaty, pensions and life annuities received by Canadian are tax exempt. Also exempt are capital gains received by Canadians. Since distribution within one taxable year from qualified plan, upon death or termination of employment, is treated as capital gain, the death benefit is exempt under either classification. *Rev. Rul.* 56-446.

No EPT relief; abnormal expense a consequence of change in operations. Taxpayer, a manufacturing plant, abandoned its power plant during the base period and was allowed a tax deduction for the unrecovered cost of the plant in excess of salvage. However, it is permitted by the court to eliminate the deduction as "abnormal" in computing its excess profits tax credit. The 1951 EPT allowed the removal of abnormal deductions from the base-period years only if they were not a consequence of a change in the manner of operation of the business. The court finds that this abandonment was a direct consequence of a change in the "manner of operation" of the business. *Electric Materials Co.*, 26 TC No. 128.

Installation of new machines does not merit EPT relief. The court holds that taxpayer's installation of labor-saving machinery during the base period was not shown to have caused diminution or interruption of "normal production, output, or operation." Excess profits tax relief is denied. *Fulton Foundry and Machine Co.*, 26 TC No. 120.

Adjustments for bad debts during base year, 1950 excess profits tax. Bad-debt loss during base period was not the result of a change in the type, manner of operation, size or condition of taxpayer's business. Taxpayer sold a part of its business at a separate location and didn't receive payment. *Collis Co.*, DC Iowa, 8/6/56.

Tax Court erred in finding income "distributable" to beneficiary. Taxpayer was income beneficiary of a trust of real estate created in 1929. Every year until 1945 expense exceeded income, but the trustees applied it to the "income deficit" account, in effect repaying corpus for the net losses it financed in earlier years. In a state-court proceeding, the trustee's accounting was sustained after a compromise. The Tax Court said that it was not bound by this compromise judgment and found the trustees in error, the income distributable and the beneficiary taxable. This court reverses. It says it agrees with the state court and therefore need not consider whether its finding binds the Tax Court. *Mueller*, CA-5, 9/6/56.

Limiting scholarships will not preclude tax exemption. The awarding of scholarships by an educational foundation solely to undergraduate members of a designated fraternity will not preclude it from tax exemption. *Rev. Rul.* 56-403.

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA
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Management can obtain and retain stock interest through close corporation

IN MOST of the corporations whose stock is listed on the large exchanges, management has little or no ownership. Stock-option plans compensate key personnel at low tax rates, but most executives don't have enough available funds to retain the stock they are permitted to buy at less than market. Use of a corporation formed by the key personnel to acquire stock in the corporation they work for will attain both of the desired ends: compensation and a stake in the business. Management will obtain a substantial ownership interest without high tax burden.

The Jones Tool Corp. (a fictitious name) is a large nationwide company, whose stock is widely held, listed on the New York Stock Exchange. Twenty key officers and employees (wholly unrelated) form Tool Investors Inc. Each subscribes to $1,000 of the stock of this corporation, receiving a 5% interest.

Tool Investors Inc. offers to buy 10,000 shares of the treasury stock of Jones Tool Corp., at the present market price of fifty dollars a share. The stock is paying five dollars a share dividend. Payment is to be made at the rate of $50,000 a year, with the proviso that if the dividends on the stock fall below that amount, the annual payment is to be reduced to the amount of the dividend. The unpaid portion will bear interest at 1% per annum. The stock will be posted as collateral.

Jones Tool Corp. accepts the offer. Tool Investors Inc. receives $50,000 in dividends the first year. It deducts the dividend-received credit of 85%, or $42,500, leaving it with taxable income of $7,500, on which the tax is 30% or $2,250. The interest deduction of $5,000 can be applied against income received on the $20,000 initial capital, but any excess is wasted because the dividends-received credit cannot exceed 85% of the net income computed without regard to the credit.

Tool Investors Inc. will have $47,750 left from the dividend. It uses $2,250 from its original investment and income it earns to make the payment of $50,000, $5,000 of which is applied to interest and $45,000 to principal. If it is desired to keep the original capital intact, the payment could be set at $45,000 a year, and the contract could provide that no more than 90% of the annual dividend shall constitute the annual payment. Depending on the dividend rate, the stock will be fully paid for in ten to fifteen years.

At the time Tool Investors Inc. is formed, a contract is entered into by all of its shareholders, under which the stock of any shareholder who dies or leaves the employ of Jones Tool Corp. may be purchased by the corporation or the other shareholders at its then value, computed by determining the market value of the Jones Tool Corp. stock, and deducting the unpaid purchase price. As a matter of policy, this stock should be sold to other employees of Jones Tool Corp. Tool Investors Inc. is not a personal holding company because no shareholder owns, directly or indirectly, 10% or more of its stock. If its membership is allowed to decrease with deaths and retirements, it may fall into that category.

When the stock is paid for, the dividends may be either paid out to the shareholders or used to acquire additional stock. It would probably be safer to pay them out and avoid the possible application of the surtax on undistributed profits. The corporation may be dissolved, and the shareholders will receive the tool-company stock at capital gains rates. However, if they keep it in existence, and pay off each shareholder as he dies, this tax will never have to be paid.

Under this plan, management has an immediate interest in the corporation, which it will retain indefinitely. Under stock-option plans, the employees are interested in seeing the market price of the stock increase, but will usually sell the stock when the option is exercised. In addition, management will be interested in seeing that the maximum dividends are paid out, which is not necessarily present when a stock-option plan is used.

When the number of key personnel is under ten, a modification of this plan can be used. In order to avoid personal holding company classification, the dividend income cannot exceed certain percentages of the gross income. The new corporation must therefore have income from other than dividends and interest. If this income is from rents, it must exceed 50% of the gross income. If this income is from operation of a business, it need be only 20% of the total. It cannot be from other types of investments, or we will have a personal holding company. Note that we are talking about gross income, not net.

If the officers of the corporation whose stock is being acquired purchase a piece of rental property with gross annual rents of $10,000, and place it in the new corporation, the new corporation can enter into a contract to purchase stock which will produce dividends of that amount annually, without creating a personal holding company. Since the rents may go down or the dividends up, it is wise to leave some leeway.

If they invest in a business with a gross annual income of $10,000, the dividends can equal $40,000 a year without creating a personal holding company. One of the best arrangements involves a farm. Instead of entering into a lease with the operator, he is made an employee, under a contract that gives him the same income as though he were a tenant. The dividend income can then be up to four times the farm income, without creating a personal holding company.

The income-producing property or business can be burdened with both a first mortgage to an outsider and a second mortgage to the owners, within the limits of the rules on thin capitalization. This will cut down the amount of

capital needed to start the venture. When the stock is paid for, the corporation can invest its funds in additional properties, and so long as the correct percentages of gross income are maintained, it will not become a personal holding company. Or it can merge with the principal company, and the officers will then acquire the stock directly without a capital gains tax.

In *National Clothing Co. of Rochester,* 23 TC 944, the employer had a plan for three employees. Under it certain stock was set aside for them to be paid for out of dividends only. There was no intervening corporation. The plan for stock purchase by an intervening corporation should be drawn so as to avoid the possibility that any excess value in the stock will be treated as compensation to the employee.

Using a Corporation to carry initial-loss venture

A WEALTHY individual or individuals embark on a business which will lose money for a substantial period. They have faith in its ultimate success, and are willing to finance it until it pays off. One man can operate it as a sole proprietor and charge off its losses, but if the losses exceed fifty thousand dollars for five years in a row, he must incorporate it to avoid the application of Section 270 (hobby losses). If it is owned by more than one individual, the owners may not wish to run the risks of a partnership, and will insist on a corporation.

In the ordinary course of events, the stockholders will have to advance sums to the corporation from time to time to finance its operations. They may be able to do this in such a way as to get a deduction in the event it ultimately fails, but since the law is in a state of flux on this point at present, they may wind up with only a long-term capital loss.

The arithmetic of the situation indicates that this corporation should be initially supplied with sufficient capital so that the investment thereof will produce sufficient funds to make up all deficits. Let us see how this works.

Assume that the corporation loses $100,000 a year. If the stockholders, in a 60% bracket, must advance this sum annually, they must earn $250,000 to do so. Since the tax on $250,000 at 60% is $150,000, they are left with the necessary $100,000. The corporation's net operating loss will go down the drain when it dissolves, and the stockholders will get a relatively useless long-term capital loss when their annual contributions are not repaid. In other words, they are out $250,000 a year.

Now, let us assume that they put securities worth $2,000,000, producing $100,000 a year, into the corporation. The income from these securities is sufficient to keep the company going. The remaining $150,000 income per year, less taxes, is still available to the shareholders. The securities will remain intact. The saving is obvious.

A closely-held corporation, whether losing or making money, is often a good place for stock investments. When it loses money, the income from the investments can be used in its entirety to make up the losses. When it makes money, the effective tax rate on the investments is only 4.5%. So long as a personal holding company is not created, funds can be amassed at a much faster rate than when they are held in the individual's name.

Capital gain on real-estate subdivision without waiting

CONGRESS ENACTED a very complicated formula for insuring that the gain from subdividing real estate would be taxed at ordinary rates except in extraordinary circumstances. Under Section 1237, an individual must hold property for at least five years, cannot improve it substantially, and must limit the number of sales annually if he wishes capital gains treatment for his profits.

In Revenue Ruling 56-303, found on page 12 of the Internal Revenue Bulletin for July 2, 1956, the Commissioner now comes along and tells us how to get capital gains on subdividing without bothering with these formalities. The factual situation involved a department store which had acquired vacant land for a new building. Thereafter it acquired another piece of property for its building. It transferred the first acquisition to a newly-formed corporation, together with some cash, for stock and short-term notes. The Commissioner said that a capital gain would be recognized to the extent of the short-term notes. The new corporation has a basis for the land equal to its original cost plus the recognized gain.

You own land that cost you $10,000, now worth $50,000. You transfer it to a new corporation for stock of $10,000 and notes of $40,000. You pay an immediate capital gains tax of $10,000. The corporation sells the property and has no gain or loss. It pays off your notes and dissolves, and there is no further tax to pay. There should be a bug in this somewhere, but we haven't been able to find it. Revenue Ruling 56-303 certainly puts the stamp of approval on it.

Of course, if the land has been held for sale to customers prior to the transfer to the corporation, the gain will be treated as ordinary. The plan may be used only for property which has been held up to the time of the transfer for investment alone. ☆

Does the Tax Court have a new test for thin incorporations?

ADVISING A CLIENT on the capitalization of a new venture—how much debt is safe—is a difficult task. Every situation differs, and there is no certain answer. Now Baxter Richardson, Fresno, California attorney, brings up the point that the Tax Court seems to be giving considerable weight in these cases to a factor not widely discussed—borrowings in the initial years of operations. Here's what he said, in the California State Bar Journal:

Those interested in close corporations have for many years sought to establish a substantial part of the capitalization as indebtedness instead of capital stock. The Treasury has traditionally attacked debt capitalization of close corporations on either or both of two grounds: (1) it has claimed that debt in reality constituted capital investment when the ratio of debt to stock was topheavy, or "thin";[1] (2) it has also attacked capitalization where the instruments evidencing "indebtedness" were ambiguous.[2]

It is difficult, if not impossible, to rationalize all the cases dealing with the characterization of securities as stock or debt. The decisions are in a state of "intolerable confusion."

Despite this confusion, it was thought that if in a close corporation the ratio of debt securities to stock was not excessive, and their form not ambiguous, the character of such securities as debt would be reasonably safe from attack. It appeared that, under such circumstances, the presence or absence of any purpose other than tax avoidance in creation of the debt structure would be immaterial.[3]

Some recent decisions, however, have

indicated that the Tax Court may not treat debt securities as such for tax purposes, even though the instruments are unambiguous and the ratio conservative.

Gooding Amusement Co.[4] seems to mark a new point of view in the court. Prior decisions, including those cited in the *Gooding* opinion, had turned on the form of the obligations and the ratio of debt to capital stock. The *Gooding* and later decisions indicate that the Tax Court now applies another criterion, even less definite and more difficult to apply than the supposed former tests—a criterion of adequate, or sufficient capitalization.

In the *Gooding* case, tangible assets of a fair value of $295,000, used by a dissolved predecessor partnership, were contributed to a newly-formed corporation in exchange for assumption of $14,000 in notes payable, capital stock of a stated value of $49,000, and notes payable over five years aggregating $232,000. The corporation also acquired existing contracts entitling it to the use of desirable locations for ferris wheels, merry-go-rounds and similar amusement devices. Although neither the predecessor partnership nor the corporation ever ascribed any value to goodwill on its books, the court said that if a reasonable value were attributed to goodwill, the ratio of debt to stock would be one to one.

The partners treated the incorporation as a taxable transaction, reporting the notes as "boot" and paying $28,000 capital gains tax thereon. During the years immediately after its formation, the corporation disposed of many of its assets, and purchased new ones at a cost of over $300,000. It borrowed additional funds during those years aggregating about $570,000. Some of these funds were borrowed commercially. The former partners lent about $160,000. The notes issued upon incorporation were only partly paid in accordance with their terms.

The court held that the payments on account of interest and principal on the notes were dividends to the recipients. The court said the form of the notes presented "no problem of interpretation" and that the absence of a thin capitalization factor was not decisive. The court said in part:

"The most significant aspect of the instant case, in our view, is the complete identity of interest between and among the three noteholders, coupled with their control of the corporation. The noteholders were husband, wife, and infant daughter, respectively. The husband held the majority stock in the corporation. It is, in our opinion, unreasonable to ascribe to the husband petitioner, F. E. Gooding, an intention at the time of the issuance of the notes ever to enforce payment of his notes, especially if to do so would either impair the credit rating of the corporation, cause it to borrow from other sources the funds necessary to meet the payments, or bring about its dissolution."

The court said that the only purpose motivating issuance of the notes was tax avoidance, and that this factor, together with "the extent to which the notes were subordinated to the claims of creditors, the reality of the amenability of petitioner's wife and infant daughter to his desires in respect of the notes, and the absence from the transaction of any time borrowing interest or new contribution to the enterprise" compelled a conclusion that indebtedness was not created.

The adequate capitalization criterion was followed in several cases. In *John W. Walter, Inc.*,[5] a four to one ratio was approved, where the stock was issued in exchange for tangible assets, and a ten-year note for distributorship franchises. The prospects of the corporation were excellent.

In the second case,[6] an 11 to 1 ratio was disapproved, where, as in *Gooding*, the business involved had been conducted as a corporation until the early years of World War II, then as a partnership, and finally reincorporated in 1946. As in *Gooding*, the corporation had to finance its current operations by further outside borrowing.

In the *Perrault*[7] case, a 500,000 to 1 ratio was approved, where valuable patent licenses representing value not shown in the books were transferred to the corporation. This corporation borrowed further funds occasionally, for a few days at a time, but apparently not regularly as in the *Gunn* case.

The only basis upon which these and other recent Tax Court cases can to any extent be reconciled seems to be that of adequacy of the equity capitalization. The reasoning seems to be that if the corporation is able to do business without further heavy borrowing, then the court will treat as debt that which formally qualifies as such, irrespective of "ratio."

It may be concluded that debt securities in a close corporation will probably be recognized as such by the Tax Court, if the securities meet the formal requirements of debts, and if the corporation receives extra intangible value upon the incorporation which renders further substantial borrowing unnecessary. Therefore, the practitioner should not regard any particular debt-capital ratio as "safe" for tax purposes if the new corporation will have to borrow further. Particularly will this be so where those interested in the business have a history of disincorporating and reincorporating in response to the changing tax climate.

Parenthetically, it may be observed that it does not seem to matter much whether or not the debt securities in question are issued together with stock upon an incorporation planned to qualify as tax-free. In the *Gooding*, *Gunn* and *Perrault* cases, the debt securities were issued in connection with a "sale" which immediately followed the issuance of stock. Where the court felt the ostensible debt should not be treated as such, it simply held that the issuance of stock followed by sale of assets were merely steps in one transaction, a tax-free incorporation under Section 112(b)(5), 1939 Code, now Section 351(a). ☆

[1] See Isidor Dobkin, 15 TC 31 (1950), *aff'd*, 192 F.2d 392 (2d Cir. 1951) (35 to 1); Swoby Corp., 9 TC 887 (1947).
[2] See Talbot Mills, 3 TC 95 (1944), *aff'd*, 326 U.S. 521 (1946); Huisking & Co., 4 TC 595 (1945); Mulling Bldg. Corp., 9 TC 350 (1947), *aff'd*, 167 F.2d 1001 (3d Cir. 1948). Compare Kelley Co., 1 TC 457 (1943), *aff'd*, 326 U.S. 521 (1946); Lansing Community Hotel Corp., 14 TC 183 (1950), *aff'd*, 187 F.2d 487 (6th Cir. 1951); Clyde Bacon, Inc., 4 TC 1107 (1945).
[3] Toledo Blade Co., 11 TC 1079 (1949), *acq.* 1949-2 CB 3, *aff'd*, 180 F.2d 357 (6th Cir. 1950), cert denied, 340 U.S. 811 (1950); Tribune Publishing Co., 17 TC 1228 (1952), *acq.* 1952-1 CB 4; John W. Walter, Inc., 23 TC 550 (1954).
[4] 23 TC 408 (1954).
[5] 23 TC 550 (1954).
[6] R. M. Gunn, 25 TC No. 54 (1955).
[7] Ainslee Perrault, 25 TC No. 55 (1955).

Citizens Utilities reversal ruling under review

WE UNDERSTAND that various Bar Association tax committees and other interested groups have filed vigorous objections to the recently-issued proposed Regulations [see 5 JTAX 117] amending Section 305(b) of the Code. The proposed Regulations not only reverse in effect the *Citizens Utilities* ruling which had approved two classes of common stock issued in a recapitalization (cash dividend type and stock dividend type);

they also seem to prevent the dual classes of common no matter how or when issued, even upon incorporation. The consequences of the proposed Regulations are serious, and it is anticipated that the objectors will soon have the opportunity to press their views at public hearings in Washington. ☆

Don't transfer close-corporation stock without look at long-time tax consequences

THE MOST FAR-REACHING thing that the 1954 Code has done, in the case of corporate shareholders, has been to greatly minimize the separate identity of members of a family group as individual taxable entities. It proceeds from the premise that transactions between members of a family involving the stock of a family corporation are tax avoidance plans unless shown to the satisfaction of the Commissioner to be to the contrary. This somewhat shocking policy concept is implemented by carrying, into the general corporate shareholder area, rules of attributed stock ownership similar to those which heretofore have been applied only for the purpose of determining whether a corporation is a personal holding company.

Though traps for the unwary lurk in the forest of securities issued by large publicly-held corporations, it is in the area of family group corporations where the impact of the new rules in the game of tax planning is most noticeable. In planning the tax consequences of gifts or bequests, whether directly or through the mechanism of a trust, it is no longer sufficient to know that husband and wife own certain shares of stock. It is essential to know how such shares were acquired, from whom, and which other members of the family also own such shares, or will own them after the plan is effected.

In these words William L. Kumler of the California bar discussed a typical possible situation under the new rules at the recent Forum on Tax Problems Affecting a Family Estate sponsored by the Title Insurance & Trust Co. of Los Angeles:

Take the facts

To illustrate the complexities confronting the holders of close-corporation stock, let us suppose that, for reasons suitable in 1955, John and Mary make gifts of shares of Smith Corporation to their son Bill, their daughter Ellen, and perhaps, also, to Bill's children. All goes well until 1957, when Ellen marries Alex. For no reason pertinent here, Bill and Alex dislike one another, which makes cooperation as employees of Smith Corporation impossible. Further, Alex has a business of his own with good possibilities that can be brought to fruition only by additional financing.

Ellen is a loving and dutiful wife and is willing to take part of her personal fortune to back his hand. Unfortunately John Smith's affairs, at the moment, are in such a posture that he can neither loan Ellen the funds nor buy her stock. Bill can't or won't. Ellen is frustrated when she learns that no outsiders are interested in buying any of her stock.

At this point it is suggested that Smith Corporation has the funds necessary to redeem Ellen's stock at book value. For these purposes we are assuming that the excess of the value of Smith Corporation stock over its basis (about $200,000) represents earned surplus rather than unrealized appreciation of assets.

Codes differ

Under the 1939 Code this would have presented a rather simple problem. The Regulations relating to Section 115 provided that if *all* the stock of a particular shareholder were redeemed by Smith Corporation, the distribution of assets in exchange for stock would have been a capital-gain transaction. Ellen would be willing to incur the capital-gains tax. Under the 1954 Code, however, the matter is complicated by a number of distasteful possibilities.

Under the new Code every distribution of assets by a corporation (having accumulated earnings and profits) to a shareholder constitutes a dividend unless it falls within certain prescribed exceptions. In this situation the necessary exceptions are prescribed by Section 302. There we find that the only transaction which will achieve Ellen's objective is a complete termination of her interest in Smith Corporation, i.e., a complete redemption of all her stock.

This seems a simple solution to Ellen's dilemma until it becomes apparent that even though all her stock is redeemed no termination of her status as a shareholder has been effected because, under Section 318, she is still regarded as owning the stock held by her parents.

Then someone notices that ownership of John's and Mary's stock will not be attributed to Ellen if, after the redemption, she is neither *a direct* shareholder, an officer, director, or employee of Smith Corporation — and does not acquire any such interest in the corporation for 10 years after the redemption, except by way of inheritance. As she is none of these (except shareholder) at present and does not expect to be, she is again prepared to surrender her stock for redemption.[1]

Fortunately, but nevertheless to the dismay of all concerned, someone reads a few lines further in Section 302. It is there provided that because, within 10 years *past*, she received gifts of Smith Corporation stock from her parents, she enjoys no relief from the rules attributing ownership of their stock to her and upon redemption of her own stock, some 2/5ths of all she receives may be taxed to her as a dividend.

Now she is at the mercy of the Commissioner. For to be assured of capital-gain treatment of the distribution of assets to her, she must apply to the Commissioner for a ruling to the effect that he is satisfied that neither the gift to her nor the redemption of her stock had avoidance of federal income taxes as its principal purpose. The Commissioner's mercies in this regard have not been notably tender.

In the situation before us, sound tax planning would have revealed that serious hazards could have been avoided by making other securities gifts to Ellen, rather than shares of stock in Smith Corporation.

Section 306 stock

The second category of significant applications of Section 318 to family shareholder groups relates to so-called "Section 306 stock," preferred stock which has been received (after the effective date of Section 306 of the 1954 Code) as a tax-free stock dividend or

[1] Note carefully that election to pursue this route prevents her receiving any further gifts of Smith Corporation stock, or taking employment there, however desperately needed, for 10 years after the redemption.
[2] 207 F.2d 462, (1953), *cert. den.* 347 U.S. 918.
[3] Section 306 stock continues to be Section 306 stock in the hands of the donee, since here basis therefore is determined with reference to its basis in the hands of the donor. Section 306(c).

which has been received in a tax-free reorganization under circumstances which made it the equivalent of a stock dividend. Under a variety of circumstances, if a shareholder "sells or otherwise disposes of Section 306 stock" which *he* has received as a dividend (or in a reorganization) the amount realized therefrom will be treated as ordinary income.

No one would be so foolish as to suggest to John that he cause Smith Corporation to issue any Section 306 stock. But let us assume that on some occasion John fell in with mountebanks and charlatans who had read the *Chamberlain* case[2] carefully (but the 1954 Code not so carefully) and who persuaded him to do that very thing. By the time John calls upon his tax adviser for guidance his portfolio of stocks and securities contains among others preferred stock in Smith Corporation. It looks innocuous enough—but it is just plain warm nitroglycerine.

John has some vague idea that he should not sell such stock so he decides to give it directly, or in trust for the benefit of Mary's aged mother, who requires some financial assistance. So long as Mary's mother (or her trustee) retains the Section 306 stock all is well. But if the mother for personal reasons, or the trustee in exercising discretion under a power to invade corpus, should sell the stock to meet an emergency need, all or a large part of the proceeds may be taxed at ordinary-income rates.

An exception to these drastic consequences is provided in Section 306(b) if in addition to selling his Section 306 stock the shareholder terminates his entire stock interest in the corporation. Here, as in Ellen's case, the simple solution would seem to be to have John's mother (or the trustee) sell all the Section 306 stock and all common stock of Smith Corporation then held, if any. But here also Section 318 operates to preclude so simple and happy a solution.

Not only would such a sale be ineffective to terminate the seller's stock interest if made to a person whose ownership would be attributable to the seller. Even if sold to an outsider, John's mother would still be deemed to own any stock held by John, Bill, or Ellen. Consequently her entire stock interest in Smith Corporation would not be terminated and the tax penalties of selling the Section 306 stock would be incurred unless, again, the Commissioner could be persuaded that tax avoidance was not a principal purpose of either the stock dividend or its sale.

The day has passed when members of a family can act independently with respect to stock which they hold in a family corporation. It is equally clear that in tax planning for a family, the plans must be laid not only with the idea of ownership in mind, but also with a weather eye cocked upon probable or possible future disposition of any stock transferred under the plan. ☆

Factors to consider under Section 269 when acquiring businesses to avoid tax

by KENNETH LILES

To COMBAT tax-motivated corporate combinations and separations, Congress in 1943 enacted Section 129 of the 1939 Code. The section permitted the Commissioner to disallow any deduction, credit, or allowance in any case where control of a corporation or property of an uncontrolled corporation was acquired, in a tax-free transaction, if the principal aim of which was to secure such tax benefits.

The Treasury's great expectations from Section 129 were never realized; it proved ineffective in preventing both tax-motivated acquisitions of loss corporations and tax-motivated multiplication of corporations. Only recently, the Commissioner won his first victory under Section 129 in *American Pipe & Steel Corporation*, 25 TC No. 45 (1955), which involved a rather obvious situation where a profitable corporation acquired control of a loss corporation and attempted to avail itself of the benefit of the losses by filing a consolidated return.

When it was faced with the excess profits tax during the Korean War, Congress decided not to rely on Section 129 alone to stop the division of corporations for the purpose of securing additional $25,000 minimum excess-profits-tax credits; it enacted Section 15(c), added to the 1939 Internal Revenue Code by the Revenue Act of 1951. Unless the taxpayer could establish by the clear preponderance of the evidence that the securing of the exemption or credit was not a *major purpose* of the transfer, Section 15(c) disallowed the $25,000 surtax exemption and the $25,000 minimum excess-profits-tax credit to a new or inactive controlled corporation to which the controlling corporation transferred property (other than money). It is too early to know whether the use of "a major purpose" test in Section 15(c) will be any more effective than "the principal purpose" test of Section 129. The Commissioner recently won the first test case under Section 15(c), on failure of the taxpayer to meet this burden of proof. See *Coastal Oil Storage Company*, 25 TC No. 156 (March 29, 1956). The 1954 Internal Revenue Code continues Section 15(c) (new Section 1551) with respect to the $25,000 surtax exemption and extends it to cover the new $60,000 accumulated earnings credit under Section 535(c) against the accumulated earnings tax imposed under Section 531 (counterpart of old Section 102).

How evasion is determined

This still left unanswered the problem of tax avoidance by corporate acquisitions. One way Congress attempted to deal with this problem was through the addition of a new presumption in recodifying Section 129 into Section 269 of the 1954 Internal Revenue Code.

The new presumption, which is contained in subsection (c) of Section 269, is entitled "Presumption in Case of Disproportionate Purchase Price." It is supposed to be "a procedural device for the determination of whether the principal purpose" of the corporate acquisition was tax avoidance or evasion. Section 269 (c) provides in effect that there is "prima facie evidence" that "the principal purpose" of the transaction is evasion or avoidance of federal income tax

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if the consideration paid upon the acquisition is "substantially disproportionate to" the aggregate of (1) the "adjusted basis" of the property of the corporation (to the extent of the interest or property acquired) and (2) the "tax benefits" acquired (to the extent not reflected in the adjusted basis of the property). This new test applies only with respect to acquisitions made after March 1, 1954.

Just what this new presumption adds to the scope of Section 129 is hard to say, since the Commissioner's determinations have always been prima facie correct and the taxpayer has always had the burden of proving that the principal purpose of the transaction was not tax avoidance. The original version of the new provision as it passed the House of Representatives made the presumption "determinative" of the taxpayer's motive unless rebutted by "a clear preponderance of the evidence." The Senate Finance Committee thought the House version imposed too heavy a burden on the taxpayer and substituted the "prima facie evidence" rule, which was finally enacted. In view of this legislative history it is hard to see why this new provision was left in the new Code. It may be that the authors meant it to be taken as a gentle hint that the courts should start deciding some of the Section 129 cases for the government.

Text needs interpretation

The particular language of the new provision gives rise to several problems, some of which may be covered by the regulations yet to be promulgated. The first problem that comes to mind is as of what date the tax benefits acquired are to be measured. If the benefits are to be calculated at the time of the transaction, there will obviously be difficult valuation problems. How can you fairly value at the time of acquisition the tax benefits expected to be derived from the transaction? Such imponderables as changes in tax rates and possible wastage of loss carryovers would have to be taken into consideration in valuing the expected tax benefit. On the other hand, it seems impractical to wait to take the measure of the value of the benefits as actually realized. To do so would leave the matter unsettled for years, and tax benefits may ultimately be realized which were not expected at the time of the transaction. Probably, the value of the tax benefits will have to be estimated at the time of the transaction.

The next problem is in determining what is meant by the phrase "disproportionate to." Literally, this phrase could cover the acquisition of appreciated property for its fair market value even though no tax benefits at all are involved. Happily, the committee reports indicate that the phrase is not meant to apply where adequate or excessive consideration is paid but only applies to the situation where inadequate consideration is paid. Presumably, the regulations will follow the committee reports and provide that the presumption will apply only if the sum of the tax benefits and the adjusted basis of the property acquired exceeds the consideration paid. The theory underlying this test seems to be that it is all right to acquire tax benefits where they are paid for in full, but, if the purchaser gets a bargain, it is bad. While the philosophy behind this concept may be open to question, the effect of such a test, if it had any teeth in it, would no doubt be a marked decrease in the traffic in sales of loss corporations.

Adequacy of consideration

There appear to be several possible peculiarities produced by the choice of the *tax basis* of the assets acquired rather than their *fair market value* as the standard of comparison in measuring the adequacy of the consideration paid. Transactions may escape that should be covered. This could happen where the assets acquired have appreciated in value to the extent of the tax benefits to be acquired and the purchaser pays only the fair market value. In such a case the purchaser will acquire tax benefits without paying for them and still the presumption will not apply. For example, assume that X Corporation acquires all of the assets of Y Corporation in a tax-free merger and that the assets of Y Corporation have a basis of $1,000 but a fair market value of $10,000 and that Y Corporation has a net operating loss carry-over valued at $9,000. Assume that the stock issued by X Corporation to the stockholders of Y Corporation in the merger is worth the fair market value of the Y assets or $10,000. In such case, the presumption will not apply, even though a tax benefit worth $9,000 has been acquired for nothing.

On the other hand, the choice of the basis test may lead to the applicability of the presumption to situations where all that has happened is that assets are acquired which have gone down in value. For example, the rule may apply where assets are acquired in a tax-free merger for $5,000 consideration which have a basis of $10,000 but a fair market value of only $5,000. The committee reports indicate that the "provision will apply to cases where the tax basis of the property acquired for depreciation and other purposes, together with the tax value of other tax benefits, such as operating loss carry-overs, is substantially greater than the amount paid for the property. Disparities of this type generally arise where the old basis is continued in the hands of the new owner." Presumably, the basis test was chosen in preference to a fair market value test to cover the situation where a taxpayer seeks to carry over high basis assets for depreciation purposes in a tax-free exchange. If this is so, one can well understand why the Senate Finance Committee may not have looked with favor on the House provision and one may be thankful indeed that the views of the Senate Finance Committee were the ones which prevailed. ☆

Liquidation followed by reincorporation: can you get tax treatment you want?

THE QUESTION of whether liquidation followed by reincorporation will be taxed lightly, heavily, or not at all continues to be a thorny problem for most tax men. We found Harold Wren's comment on this particularly worthwhile. Says Professor Wren (of law at the University of Oklahoma, in 43 *California Law Review* 284):

Assume a corporation has extensive cash resources. Such a corporation could carry out a complete liquidation, distributing all the assets to its shareholders. The shareholders would then retain the cash, and transfer the business assets to a new corporation which would continue the operation of the business. Section 357 of the House bill sought to tax such a complete liquidation followed by subsequent reincorporation in much the same way as a redemption essentially equivalent to a dividend, un-

less the taxpayer could establish that "such transactions did not have as one of their principal purposes the avoidance of tax on corporate distributions of property."

This section was omitted from the Finance Committee's version of Subchapter C. The report of the Conference Committee, however, makes it clear that this particular device cannot be used to get earnings out at capital-gains rates. Said the Committee:

"This provision gave rise to certain technical problems and it has not been retained in the bill as recommended by the accompanying conference report. It is the belief of the managers on the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill."

Despite the Conference Committee's optimism with respect to the eventual disposition of the problem of liquidation and subsequent reincorporation, the fact remains that the new Code does not prohibit this device for getting earnings out at capital-gains rates. The Finance Committee also eliminated the definition of "complete liquidation" which appeared in the House bill but provided without qualification that "amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock" [Section 331(a)(1)]—in other words, such distributions shall receive capital-gains treatment. Moreover, the Finance Committee added another section providing that Section 301, relating to the method of taxing dividends to shareholders, should not apply to "any distribution in partial or complete liquidation." In the face of this language, the "plain meaning" rule of statutory construction will have to be ignored by the Commissioner and the courts to accomplish the result expected here by the Conference Committee.

The Regulations provide [TD 6152, Section 1.331-1(c)] that a liquidation followed by a transfer to another corporation of all or a part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of "other property." ☆

New corporate decisions this month

Return on stock not deductible as interest. A 5% return on "preferred stock" carried on the books as capital stock is a dividend and not interest paid on borrowed capital. Taxpayer argued that the preferred was in reality a debt, not equity, called stock only to avoid a liability on the balance sheet. The court refers to the fact that the parties called it stock as a "determining factor." *Crown Iron Works Co.*, TCM 1956-199.

Sums advanced to family corporation were risk capital. Taxpayer organized a construction corporation which began business with an investment of $610 in liquid assets. The major part of its working capital throughout its existence was obtained as advances from taxpayer's wife. Although its accumulated surplus at the end of the taxable year was approximately $60,000, the amounts contributed by taxpayer's family on that date totaled $140,000. From all the evidence the court concluded that the advances and contributions constituted risk capital. An "interest" payment of $8,400 is therefore disallowed as being essentially a taxable dividend. *Ryan Contracting Corp.*, TCM 1956-188.

Cancellation of stockholders' notes a dividend. A syndicate purchased all of the outstanding stock of a corporation from its former stockholders by, in effect, borrowing the money from the corporation on promissory notes. The stock certificates were held by the corporation as security for the payment of the notes. The notes were canceled by the corporation two years later in exchange for 75% of the stock. The syndicate members are held to have realized a taxable dividend to the extent of the accumulated corporate surplus. *Bell*, TCM 1956-191.

Common stockholder is not taxable on value of convertible debenture rights attributable to conversion privilge. Accepting the premise that substantially all the value of rights to subscribe to convertible debentures, issued in 1954, applied to the conversion privilege, the Service holds that the receipt was nontaxable. The conversion permitted was to common stock, and the rights were issued to common stockholders. *Special ruling*, 6/27/56.

Exchange of municipal bonds is nontaxable; same debt is continued. An exchange of 5½% City of San Antonio Water Works Bonds of 5½% City of Antonio Revenue Bonds in the same amounts and maturing serially in the same years is not taxable. The exchange was in reality merely a continuation of the old debt. *Rev. Rul.* 56-435.

Publisher of four magazines can spin off one tax-free. Taxpayer published four trade magazines, one for the metal-working field, the others for the electrical industry. It transferred all the assets pertaining to the metal magazine business to a new corporation in return for all the latter's common stock, which was then distributed pro rata to the shareholders of the old corporation. The transaction is held to constitute a nontaxable spinoff reorganization. The metal magazine had separate editorial staff and salesmen, and it was a business separate from the electrical magazines. *Rev. Rul.* 56-451.

Distribution of competitive subsidiary to minority tax-free. A printing corporation owns 80% of a type-setting corporation. For valid business reasons, it intends to divorce itself from the ownership of the type-setting subsidiary by distributing the stock to a minority of its stockholders in exchange for all the stock they hold in it. Both corporations will continue to engage in the conduct of their respective businesses after the exchange, and no sales of stock are contemplated. The Service holds the splitoff is nontaxable under Section 355. The type-setting subsidiary is a controlled corporation; both are engaged in the active conduct of their businesses and have been for five years. *Rev. Rul.* 56-450.

Organization taxes of merged corporation deductible on merger. Taxpayer claimed a deductible loss for Pennsylvania franchise tax on capital stock paid during the 1920's by a Pennsylvania corporation merged into it in 1951. The Government conceded the deduction would be allowed if the Penn-

sylvania corporation had been dissolved. This court sees no difference between a merger in which corporate identity is completely lost and dissolution. Deduction allowed. *Dragon Cement Co.*, DC Me., 8/24/56.

Stock redemption not dividend if used for expenses even though deducted on income tax return. Section 303 provides that under certain conditions redemption of stock held by an estate is not a dividend to the extent of estate taxes. The 1954 Code added funeral and administrative expenses to taxes. The Service holds that it is irrelevant whether the estate elected to take these expenses on its income tax return; they are "allowable for estate tax" even though they are not so used. Both pre-1954 and post 1954 expenses are allowable. *Rev. Rul.* 56-449.

Waiver of dividends by majority stockholder doesn't prevent tax; his relatives benefited. Taxpayer waived his right to receive his pro rata share of dividends paid by a corporation, of which he was the majority stockholder. The Service will not recognize the waiver for income tax purposes; his pro rata share of the dividends was paid in the form of increased dividends to his relatives and employees as minority stockholders, and the waiver resulted primarily in benefiting the relatives. Income is realized by the taxpayer to the extent of the dividends waived. *Rev. Rul.* 56-431.

Dividends prior to decision to liquidate are ordinary. The dividend checks were stamped "partial liquidating," but the resolution to discontinue the business came later. The dividend is ordinary income. *Ronning*, DC Minn. 6/25/56..

PHC penalized for not filing, though it didn't and couldn't know of indirect stockholdings. Conceding that its entire income for the years in question was personal holding company income, taxpayer contended that it was unable to determine that it was a personal holding company because only when the stock owned of record by a corporation was included as indirectly owned by one person did five or fewer shareholders own 50% of taxpayer's stock. Taxpayer said it did not know, and could not have known, that the corporate shareholder was beneficially owned by one individual. The court concludes taxpayer was subject to a 25% penalty for failure to file personal holding company returns. Since taxpayer admittedly never attempted to ascertain its true status, nor did it ever seek professional advice on this matter, the failure to file was not due to reasonable cause. *Coshocton Securities Co.*, 26 TC No. 117.

INDEX OF NEW DECISIONS REPORTED IN THIS ISSUE

NEW DECISIONS are listed below by the single significant word in the citation, generally the taxpayer's last or principal name. The number is page where summary will be found.

Alexander Estate	265	Faulk	288	Musser	278
Algodon Mfg. Co.	279	Field	264	Nashville R.R.	309
Aller	270	Finston	289	Nourse Estate	265
Babson	289	Flora	287	Nunan	278
Bailey Estate	265	Friedlander	286	Overly	289
Baker	265	Friedman	296	Pence	270
Balanowski	313	Fulton Foundry and Machine	313	Pfleiderer	262
Bell	320	Gibson	296	Pilot Freight Carriers	287
Bradley	286, 288	Gibson Wine Co.	309	Pittston Co.	286
Brill	297	Goodman Co.	288	Ravencliffs Devel. Co.	278
Burrough Operating Corp.	289	Goldberg Estate	279	Rictor	270
Byers	270	Gross	286	Richards	296
Calvert Iron Works	296	Hall	289	Robertson	265
Carter	288	Harrisburg Steel Corp.	289	Robinson	297
Clark	296	Haskell	279	Rogers	296
Collis Co.	313	Hicks	279	Ronning	321
Coshocton Securities Co.	321	HJK Theatre	297	Rosenberger	278
Crosby Estate	264	Hub Cloak and Suit Co.	297	Ryan Contracting	320
Crown Iron Works	320	Jacquemot	270	Rylander	286
Davis	297	Jefferson Lake Sulphur Co.	288	Sands Estate	265
Dayton Rubber Co.	309	Jefferson Loan Co.	279	Skopil	286
Diaz-Albertine	278	Kahua Ranch	287	Smith	288, 297
Dorminey	288, 289	Klinghamer	279	Stanley	262
Dragon Cement Co.	313, 321	Kurtin	287	Snively	286
Dunlap	289	Lias	296	Stern & Stern	279
Ebner	287	Lenny	279	Sunland Industries	279
Electric Materials Co.	313	Licovali	279	Tarr	296
Fairmount Cemetery	287	Lopez	296	Thayer Estate	265
		Mitchell Estate	264	Veino	296
		Moritz Estate	278	Willing Estate	264
		Mueller	313		

REVENUE RULINGS: The first number is that of the Ruling, the second is the page number where a summary of the ruling will be found.

56-288	313	56-434	287
56-397	264	56-435	320
56-398	287	56-436	287
56-399	270	56-437	288
56-400	289	56-438	265
56-401	270	56-439	265
56-402	287	56-445	279
56-403	313	56-446	313
56-404	313	56-448	289
56-405	287	56-449	321
56-406	286	56-450	320
56-413	279	56-451	320
56-416	270	56-452	262
56-418	270	56-472	288
56-420	287	56-477	289
56-421	264	Rev. Proc. 56-27	279
56-431	321	Special Ruling	320
56-433	287		

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